Policy, Planning, and Research

WORKING PAPERS

International Economic Analysis and Prospects

International Economics Department
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Can the Industrial Countries Return to Rapid Growth?

A Seminar Sponsored
by the International Economics Department

Most participants in this lively discussion agreed that we are not likely to return to growth rates well over 2.5 percent in the medium run — unless some policy yet to be defined emerges — and that this slowdown will particularly hurt developing countries. There was a consensus that something must be done to stabilize exchange rates.

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In January 1988 the International Economic Analysis and Prospects Division of the International Economics Department held a one-day round table seminar on the prospects for economic growth in the industrial countries in the 1990s. Following are highlights from the discussion:

Andrea Boltho: Even if, in an ideal world, Japanese savings ought to be exported to Latin America, we are not in that ideal world: we are in the presence of major imbalances, whatever intertemporal shifting might lead one to expect. Is it, therefore, inevitable that the next few years (1989-91) will see a recession? And if we see a recession, will it be coupled with inflation — or will we at least be able to avoid one or the other of these two possibilities?

What would bring us to a higher growth rate? The only thing that the Fund has to recommend is policies of deregulation. Frankly, I am far from convinced. For one thing, the 1950s and the 1960s were almost certainly a period in which regulations increased, in which the Welfare State became more "oppressive," in which labor legislation got more binding. Yet our growth went on and on and on, apparently unperturbed.... it doesn't look as if these micro distortions were quite as important as people tried to make them out to be. [On the other hand, one kind of deregulation] has had extremely serious negative consequences for our growth performance: deregulated [foreign] exchange markets.

Flemming Larsen: Expansionary fiscal policies perhaps were pursued a bit too long [after the war] with the result that wage expectations became unrealistic relative to underlying productivity growth, with the result that wage earners and unions in many countries essentially forgot that they also had a kind of responsibility for what happened to real wages and thereby demand for labor.

Jean Baneth: Growth is like a bicycle. If it slows down too much, it may fall. And I personally believe that because of both political and social restraints, as you fall below or try to stay at 2.5 percent, the long-term outcome may in fact be much slower growth.

Leslie Lipschitz: One of the problems might well be that Americans understand very little of the problems of Europe and are not persuasive in talking about Europe, and I suspect vice versa — that sometime when one listens to this debate, it sounds like a dialogue of the deaf.

Steve Marris: None of our models take into account the interreaction between price elasticities and income elasticities. You know, what every other country has learned is that if you combine an undervalued exchange rate with a recession, miracles happen. They happened in Brazil; they happened in Mexico; they used to happen from time to time in France. There is every likelihood that they could happen in the United States.

I suppose what we need is a crisis serious enough [that we can] lock the governments into a better managed exchange rate system, but not so serious that the whole thing breaks down and there is nothing left to manage.

This paper is a product of the International Economic Analysis and Prospects Division, International Economics Department. Copies are available free from the World Bank, 1818 H Street NW, Washington DC 20433. Please contact Jackie Queen, room S7-212, extension 33740 (55 pages).

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INTERNATIONAL ECONOMICS ANALYSIS AND PROSPECTS DIVISION

PREFACE

In January 1988, the International Economic Analysis and Prospects Division (IECAP) of the International Economics Department, as a part of its ongoing research activity on global prospects, held a one-day, informal, round-table seminar to evaluate various views concerning prospects for economic growth in the industrial countries during the decade of the 1990s. The seminar was titled: Can The Industrial Countries Return To Rapid Growth?

This volume contains the main body of the discussions that took place at that seminar. The participants, whose name list appears below, were invited by Mr. Jean Baneth, Director of International Economics Department, from a cross section of international organizations and private research institutes. The meeting was held at the Bank and was chaired by Mr. Baneth.

The following set of background papers were sent to each invitee, prior to the meeting, in order to help organize the discussions around a given theme:

Andrea Boltho, Can We Return to Rapid Growth?, Division Working Paper No. 1987-4, IECAP, World Bank, December 1987; subsequently a revised version of this paper has been released as a PPR Working Paper, WPS 9, World Bank, June 1988.

World Bank, World Development Report 1988, Draft, December 1987.

Paul Armington and Shahrokh Fardoust, A Comment on the Outlook in the Light of Professor Boltho's Paper, mimeographed, IECAP, World Bank, January 1988; a revised and updated version this paper, retitled Long-Term Prospects for the World Economy, will soon be released by IECAP.

The editing has been kept to a minimum, and what is reported here is nearly identical to the actual deliberations during the meeting. Nevertheless, in order for the document to be more readable, three types of changes have been introduced to the original document, which was based on the sound recording of the seminar. All discussions not directly concerned with the main theme have been taken out; unfinished or incoherent sentences have been edited, mainly by the participants themselves; other changes have been put in brackets [ ]; and, finally, an attempt has been made to identify the sources of some of the items that were referred to by the participants at the meeting (i.e., reports, published scholarly articles, etc.). The result is a document that contains a number of interesting and stimulating discussions about the major global economic issues in the context of the long-term prospects for the industrial economies. We hope that this, and other similar products planned for future release, will be found useful by the Bank staff.

The initial editing and the arrangement of the text were done by Shahrokh Fardoust; Jacquelyn Queen was responsible for the word processing and the production of the document.

International Economic Analysis
and Prospects Division

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PROCEEDINGS

PART I

(Morning session 10:am)

MR. BANETH: The main document around which I would like to structure the meeting is Professor Boltho's attempt at describing the constraints on growth and what he sees as the means for accelerating it in the industrial countries; and the economic, social and political implications for the developing countries if we could accelerate growth, or indeed if it slows further.

Can We Return to Rapid Growth

PROF. BOLTHO: I don't expect any of you to have read my paper because it is immensely long. So I will briefly summarize it first and then mention some of the possible issues which we might discuss this morning and this afternoon. The paper is an attempt at seeing what the constraints on long-term growth may be. It takes a historical approach. It goes back in time quite far.

It makes a very convenient assumption at the outset which is to ignore virtually all the real important problems. The issues of the dollar, of the deficits, of the imbalances, of debt are swept under the counter, which is very convenient, but obviously dangerous, and it concentrates on the conditions for rapid growth thereafter. In other words, it assumes that in some way or another we will be able to get out of the present mess in a non-defined time horizon, five years, eight years, possibly twenty-five years.

And it says, well, let's assume that we can get out of the various imbalances which beset the world economy today, can we then get back to a growth trend that is about the 2 to 2-1/2 percent per annum that we have been experiencing since the second oil shock?

Now I admit that while it is convenient, it is a dangerous assumption if only because the transition, the way in which we get out of present day imbalances will color the future growth prospects of the world.

The other assumption which I make, in looking at longer-term growth, is a very simple one -- a justified one -- which is that investment is the main engine of long-term growth. It is when investment accelerates that growth accelerates as well. For individual countries, exports can take that role; exports can be an engine of growth, but I am not interested in the experience of individual countries. I am interested in the experience of all the industrialized countries at the same time.

The reasons why I am such a strong believer in the virtues of investment are spelled out in the paper. And, in turn, investment, which determines longer-term growth is strongly linked with technological progress, and is a function of optimistic expectations, be these of profits or be these of future demand. I don't want to enter into the Keynesian versus Neo-classical controversy. I just say that, in fact, the two tend to be correlated over the cycle and over the medium-run anyway.

Therefore, it is optimistic expectations that generate upswings in investment, and it is upswings in investment, in turn, which lead to acceleration (or decelerations in the opposite case) in the growth path of the world economy.

What are these expectations function of? Well, there the field is more open, as far as I am concerned. There are various views on what may generate favorable expectations. One of them is the idea that we are subject to virtually inevitable cycles in optimism, pessimism, investment activity and so on, which have gone under the name of Kondratieff cycles.

Importance of System Shocks

But there are two other views which I think are more interesting, one of which would stress the importance of deregulated markets and spontaneous market forces, very much the present policy orthodoxy in stimulating entrepreneurial activities. The other one, on the other hand, would stress what I call system shocks, but I do not only want to call them system shocks, special impulses which appear from time to time, often in an ad hoc way, which can come from wars, from change in trading regimes, but also importantly from economic policies.

So it is really between these two, in a sense, opposite views, I think, that the debate may be placed.

What does the empirical evidence show, if anything? I don't think it shows that much. It shows what Paul Armington and Shahrokh Fardoust call in their paper the sort of ineluctability of 2-1/2 percent per annum. If I take the Angus Maddison's data for 16 industrialized countries [see Phases of Capitalist Development, Oxford University, Press, 1982], which go back at least a century and possibly a bit more, one finds that indeed over most of the time the growth rate of industrialized countries has been roughly 2-1/2 percent per annum.

And I have tried with a certain amount of ingenuity, I think, to find periods of acceleration and deceleration within this long-run historical experience and basically, apart from the obvious 1950s and 1960s, which are a clear exception to the general trend because of very sharp sudden acceleration, I can at best come up with two periods of very mild acceleration in the 1850s and 1860s and again at the end of the 19th century. The accelerations are mild;

the periods are very removed. The lessons, therefore, we can draw from them may be very limited.

In the choice among: Kondratieff, spontaneous market forces, and system shocks (which I don't test econometrically) -- I dismiss Kondratieff if only because I find very little regularity that one can observe in the cycles. There may be some price regularities, but clearly it is not quantity regularity.

In any case, none of the explanations I have come across for the presumed regularity of such cycles seem to hold much water.

Between, these sort of shorthand titles of spontaneous market forces versus system shocks, I find that at best the "spontaneous school", a sort of deregulated market school, can no doubt provide some explanation for the Industrial Revolution of Britain in the 18th Century, and possibly for the acceleration of the 1850s and 1860s. By the turn of the century already, I think the role of economic policies but also possibly of gold discoveries and colonial adventures becomes more important, and possibly also protectionism becomes more important. For the '50s and '60s my reading of the evidence (biased as it may be) is strongly in support of the idea that economic policies played an extremely important role.

Physical factors were no doubt permissive, but similarly permissive physical factors that existed in prior periods of economic history -- abundant labor, cheap technology, cheap energy -- had not generated super rates of growth of the order of magnitude of 4-1/2 to 5 percent. What was different on this occasion, to my mind, was the much greater role that government policies were taking in preserving employment, preventing business cycles and, in many countries, trying to accelerate growth.

And my view that system shocks matter is also confirmed in a paper by Reynolds in the <u>Journal of Economic Literature</u> [June 1987, pp. 649-698] on the experience of developing countries, again a long-run brush history of developing countries -- which suggests that for virtually all those developing countries which shifted the growth tempo from a fairly steady to an acceleration of growth tempo, to a much more rapid growth in per capita incomes, this is associated with exports on the one hand but with some political shock or other on the other. So the real system shocks doesn't seem to be applicable only to my very broad brush view of the industrialized countries' accelerations through time, but could also fit individual experience -- not as a group, but of individual experience -- of a large number of developing countries which Reynolds looked at in detail.

The Supply-Side...

So much for the past. Now what about the future? Does any of this suggest that we are stuck with a 2-1/2 percent or even less growth forever? Or does any of this suggest that we could return to a faster growth rate of output and activity at some future date?

One issue that often preoccupies economists is the issue of whether the supply would be there. Could the industrial countries (once we get rid of the U.S. deficits and so on) actually grow at 4 percent? Is the labor there? Is the capital there? Is the technology there? Are the savings there? My biased conclusion is that most of these problems have been overstated.

On the labor front, I would have thought that there was a fair amount of available labor in most of our economies. I mean, the United States today may be an exception in that it is close to full employment; but then the growth problem is more an European and, perhaps, Japanese problem than it is an American problem, at least at present. In Western Europe in particular, to my mind, there are ample supplies of labor. Take the British example, as a case for an extremely rigid labor market. In Britain, the natural unemployment had risen pari passu with the actual unemployment, to about 3 million. Over the last year, British growth has been very rapid by international standards. Unemployment has fallen rapidly and sharply, and there have been no upward pressures on wages. Wages have grown rapidly but they were growing already beforehand while the British economy was not growing rapidly. There has been no upward inflationary pressure and labor has been reabsorbed into the economy.

On the capital side, there may be need for a bit more caution, if only because ten or fifteen years of slow growth have led to a shortfall of investment and hence to capacity problems. Again, Britain doesn't seem to be evidencing these capacity problems, nor Japan, whose growth has also accelerated significantly -- apparently thanks to a fiscal boost. But the rates of capacity utilization at present, for instance, do not suggest that the margins of spare capacity are as large as one might have expected after ten or fifteen years of slow growth.

Nonetheless, my prudence ought to be colored by experience of the 1950s and 1960s, for instance, when we were running very close to full capacity utilization. Capacity was fully utilized in all the OECD economies for a long-run of years. Yet, we could go on growing at 4 to 5 percent. Demand just created its investment needs and the capacity that went with it. With the large margins of spare capacity we have now, one would think that the scope for expansion was there. And, as expansion took place, because of the accelerator mechanisms, the investment would then follow.

Raw materials...

On the raw materials' side, I would doubt that there can be very many problems for primary products other than oil. And even for oil, I would have thought the chances of OPEC sharply raising prices again are remote unless we really were to accelerate to an inconceivably rapid growth rate, to 4 or 5 percent for ten years. Then, no doubt, we might face problems in the oil market again. But this is clearly not on the cards. And perhaps influenced by the present oil market situation, I predict that oil will not be a major constraint on future growth.

On the physical side, the other issue often mentioned is technology. We all think that technology is frightfully important, but we don't know how to measure it. We don't know whether it is there or not. Casual empiricism and journalistic reports will suggest that there is plenty of technology available. We are innovating in robots and flexible manufacturing systems, electronics, telecommunications, etc. But I am not sure that that cuts much ice.

Scientific and Technological Factors...

Whether we would be hitting problems on the innovation, in the technology froutier is -- to my mind, an open issue. I am struck by some of the evidence I have seen which suggests that even technological innovations are strongly influenced by the pace and the speed of demand itself. The application of inventions tend to follow the cycle, investment, and seem to be a function of demand forces.

So that if we were able to accelerate a bit, technology may well adapt to the acceleration, just as when a relatively low output growth may be leading to a relatively low rate of innovation and structural change.

All these are really types of physical bottlenecks -- labor, capital, raw materials and technology. But there are some less physical bottlenecks. One such bottleneck is savings. The possibility that even if we did wish to invest, and even if optimistic expectations materialized, we would be hitting an availability of savings bottleneck, which would drive up interest rates and/or inflation and therefore frustrate the attempt at growing at a faster rate.

True to my unreconstructed Keynesianism, I consider savings to be a function of income. And if income grows, savings grow. But I must admit that the recent U.S. experience has thrown some doubt in my mind about the universal validity of this proposition.

Looking at past experiences of acceleration in growth rates, virtually anywhere higher savings followed. This seems to have been the case even for the United States through the 1950s and the 1960s. But in the early 1980s, United States investment grew rapidly, Government expenditure, of course, grew rapidly as well, while savings, despite rapid income growth, did not follow suit, and hence you had the well-known absorption of savings from the rest of the world.

There are some arithmetics in my paper [PPR Working Paper, WPS 9], which suggests that if we wanted to get back to the investment ratios of the early 1970s, the very peak ratios we ever recorded, and if U.S. savings were not to move from the savings achieved at present over the last cycle, over the last few years, then the rest of the world, the rest of the OECD area would have to increase its gross savings ratio to GDP to levels very rarely recorded in the past. Therefore, it wouldn't be totally unfeasible to get back to an investment ratio like that of 1973, but it would be difficult.

Physical constraints to growth?

Where does this discussion lead me on this sort of physical constraints to growth? Most of them, I think, have probably been overplayed. It is typical of periods of slowdown and of recession to suggest that structural difficulties, rigidities and shortcomings have beset the world economy. That was said during the so-called Great Depression of the '70s and '80s of the last century. It was definitely said in the 1930s. Everybody kept arguing that in no way could we ever get out of slow growth. It is being argued again in the 1980s.

I would have thought that both the experience of those few countries which grew rapidly in the course of the '30s as they changed their policies, as well as the experiences of the '50s and '60s suggest that these fears are not fully justified.

Nonetheless there may be some truth to some of these fears and hence there may be a need for caution in any stimulation of activity or in any system shock which we may want to impart to the system. But I don't think the case is that important and that strong as a lot of contemporary orthodoxy would lead one to believe.

If one assumes that the supply potential is there, at least for a rate above the 2-1/2 percent which we have been experiencing for a long time, say, 3 to 3.5 percent, ideally 4, how can we get to it? Now one problem is the physical capacity. The next problem is: What sort of either policies or other events can get us back to relatively rapid growth?

One idea, of course, would be just a return to Keynesian-stimulated policies. I see there a much more important constraint, not a physical one, but in a sense one of attitudes. Keynesian policies now are surrounded by a very large degree of skepticism. People don't believe in their efficacy. Even when their efficacy to my mind is supported by both British and Japanese experience in 1986-88 period, nonetheless there is profound skepticism about them; hence, the chances of regenerating activity just by returning to more expansionary policies, larger budget deficits and so on, are very limited.

Another possibility -- and this now goes back to the transition phase itself -- is an orderly transition from the present problems. If we can get out of the present mess possibly in a cooperative fashion (i.e., a gradual and orderly unfolding of the global payments imbalances) combined with a much higher degree of optimism, we could generate the system shock which to my mind is essential for a return to high growth.

In other words, just as growth in the 1950s and 1960s was very rapid, thanks partly (or largely to my mind) to a regime change, a move from basically laissez-faire government policies to much more interventionist in the macroeconomic field by government policies, a regime change could occur in the late 1980s where we move from basic-

ally national sovereignty over government policy to a much larger degree of international cooperation in government policy. This could be the system shock of the 1990s and could get us out of the present problems, in an orderly fashion.

If the transition is disorderly, i.e., inflationary, as Paul Armington suggests, or is achieved via a much more profound recession than presently on the cards, then I would have thought that the chances for growth in the 1990s are that much dimmer, that much worse, capacity or no capacity, because the policy background would be so much less favorable.

Therefore, to my mind the issues are, on the one hand, this broad idea of whether the capacity is actually there, and growth can go beyond the 2-1/2 percent rate; secondly, what is the nature of the transition process. Is it likely to be favorable, orderly, smooth or, as I fear, is it instead going to generate inflation or recession, or conceivably both? And thirdly, if that were the case, what other system shocks, if one believes in the system shock idea, would be necessary or desirable to get us back to a faster growth path at a later stage, towards the end of the 1990s?

MR. BANETH: *Perhaps we can, in fact, take as not yet fully resolved the short-term transition problem, and start the discussion on the nature of the short-run problem and how we could get out of it.*

I have a great deal of sympathy with Boltho's analysis and his findings, including the conclusion. It is that conclusion which generates profound pessimism. It is difficult to see the leadership or the policies or the social attitudes, which in fact will allow us to return to faster growth. There are a couple of issues that I would like us to discuss here. One is the social consequences in the industrial countries if we do not return to faster growth. Fifteen years ago there was a general expectation that if unemployment reaches, say, 5 percent in Europe, there is going to be a catastrophe. And to use a French expression, some people have referred to the Divine Surprise, that you could go above 10 percent and not get revolution.

But I personally am not convinced that these things happen immediately and without lags, and the fact that we had only limited harmful political and social consequences in the short-run does not necessarily mean that this can continue.

Obviously, for us of greatest interest is the impact of all this on developing countries. There was a lot of talk of decoupling growth. Is that likely to happen? What is the interaction both ways? How do the developing countries contribute to this process, negatively through debt crisis and other negative system shocks, or *perhaps positively through generating the demand which can provide the burst of acceleration in growth rates?*

Complex of Investment Technology and Structural Change

MR. OHLIN: I would like to organize my comments under three headings to make it simpler rather than to follow the [Boltho] paper as a whole. Those would be, first of all, the complex of investment and technology and structural change; secondly, the role of policies; and thirdly, the international system and its imbalances.

Let us start then with growth and our understanding of it. There is, in the paper, a devastating survey of growth theory and attempts to understand growth in the past. It makes it perfectly clear how little consensus there really is on the interpretation of historical growth, but also, for that matter, on the post-war Golden Age. The author cites a great many divergent views.

He may have gone a bit too far in the assumption that all these views are borne equal, and there might be a bit more consensus about what the important ideas are and what the less important ideas are. Nonetheless, the basic impression of great intellectual confusion prevails.

This must be of particular importance for those of us in international organizations who are supposed to know and are expected to tell countries what they can do to get more growth. The fact is that no one knows very much about it, and this ought to make for a great deal of humility.

Let me return to the assertive rather than to the destructive aspects of the paper. If I understand Boltho correctly, he says that in generally stable conditions, with an ample supply of labor and other requirements met -- including the supply of entrepreneurs -- growth should be pretty automatic if investment is incited by expectations. And as far as the irregularities that we have observed in the past go, they should be understood to have resulted from disruptions, some of which might stem from economic policy.

This is pretty close to a neo-classical approach. The difficulty I have with this is over the approach to the nature of growth and the sources of growth. One should not, it seems to me, dismiss technology as assiduously as Boltho tries to do. He raised the question of technology, but he nonetheless concludes that one can afford to disregard it.

I think he is rightly ridiculing the fatalistic approach to Kondratieff, but I think that is flogging a dead horse. Nonetheless, when Schumpeter named the Kondratieff cycle, there was more to it than just reference to Kondratieff.

What Schumpeter very imaginatively incorporated in his conception of growth in technology is worth retaining. And Boltho doesn't really raise this in his paper. He cites Schumpeter on the decline of capitalism, not on the importance of entrepreneurs.

Schumpeter's idea of the link between the growth and the cycle, for instance, was meant to relate to the consequences of major technological breakthroughs. He suggested that one could make a distinction between fundamental ones, which would pervade the economy completely, by changing the sources of energy and so forth, and less important ones. That seems to me to make a lot of sense.

And above all, the conclusion that he drew is one that I think is surprisingly neglected, and that was that the introduction of technological breakthroughs in some area or other was bound to be followed by problems of absorption and by a great deal of competition between the old and the new technology and, therefore, a slowdown in growth with rising unemployment.

What interests me in this approach is the plausibility and realism that I find in such an approach to technology as distinct from the idea of simply putting it into a production function and assuming that it will have a smooth and even impact on factor productivity.

So on this score I think Boltho has underestimated the role of technology. While it is difficult to measure the role of technology as Boltho argues, that seems to me to be beside the point. There are lots of things in economics that can't be measured.

I have been intrigued by the importance that Boltho has attached to growth policies or macroeconomic policies in general in determining growth. I think I might buy in the short-run the idea that policies can do a lot to slow down growth and hold investment back.

But that seems to me to ignore another common sense observation of a historical nature, which Boltho does comment on, namely the role of institutions, the role of microeconomic aspects, which is a very big black box. To that Boltho adds the legal system, government regulation, educational policy, technology policy, and foreign investment policy. I think these deserve considerable attention here, not just in developed countries but quite particularly in developing countries.

In the paper by Reynolds [JEL, June 1987] the conclusion was that over 150 years the only conclusion one could draw of growth that what really mattered most of all was political stability and good public administration. This is of course not much if one wants to say something interesting about growth. But it is a minimalist approach.

I think one could probably say more than that. It is often said that we don't have controlled experiments and so forth, but we have a fantastic array on which to base comparative studies, and above all we do have these remarkable instances of successful growth and government promotion of growth -- Germany in the 19th century, Japan in this century, the new NICs and so forth.

The Germans and the Japanese in the times of their glory didn't have any macroeconomists around at all, and their approach was totally different. They went out to look at other countries in the world and see what they were doing and to adapt their institutions to their own conditions. And they had programs, common sense programs for modernization of their countries. These were essentially political institutions.

Simon Kuznets, for all his work on growth, was always very careful to insist that he didn't understand it at all. And he was very close to this minimalist view. He did think that it was important to emphasize the convergence, the confluence of changes in different parts of society, economic, political and institutional and so forth, and our mutual support to influence them. I think some of this Kuznetsian perspective is helpful also when we look to the future.

Present Policy Challenges: The Massive Imbalances...

Now I come to the problem of external payments imbalances. Prof. Boltho hints towards the end of his paper that the presumption for what he is saying is that we get over these imbalances, that we unwind these imbalan-ces, and that nothing can really happen before we have done that.

Well, I am beginning to react against this sort of conventional wisdom. I don't think that the issue is how we are going to unwind the imbalances. I think the question is how they are going to be reduced to a level where they are sustainable, where the financing of deficits and flows, which by historical standards are not all that great and which by any approach to growth are not very difficult to understand, will again be possible.

And this leads me to say something about the premise that we are in a situation with imbalances which are widely agreed to be unsustainable. Precisely why is not always made clear.

It seems to me there are two fundamental dimensions to this question of sustainability. One relates to the debtor side. If interest rates are much higher than the rate of growth of repayment capacity and this lasts for a very long time, then obviously arithmetically you are in a hopeless situation. At the same time, there is a case for bridging finance when this is not going to be so in the lending phase.

In the 1960s, I remember that in the OECD and here at the World Bank we talked now and then about the point of no return beyond which we couldn't go in financing deficits if the situation was unpropitious. It might be wise to take a look at that kind of problem again.

But the other dimension to sustainability relates to the stability of the international system and the degree of risk that creditors are willing to assume, and the assessments they make of the future. Is it likely that the repayment capacity is going to remain as low as it is and so forth. This is where stability in general and institutional arrangements are fundamental to the molding of the expectations that you, I think, quite correctly found so essential to investment.

I would reverse the order, and say that we are not likely to unwind the imbalances and thereby return to stability. We are going to have to find stability in order to live with the imbalances, not necessarily at the present magnitude, but it is unreasonable to assume that we are going to be able to get rid of them terribly quickly.

MR. BANETH: Can one live with the imbalances, unwinding or not, and to what extent? Which precedes what? Are there ways of unwinding them which promote stability, and what are those ways?

More on current account imbalances

MR. LIPSCHITZ: I found Professor Boltho's presentation quite fascinating. The strongest evidence for your [Boltho] being an unreconstructed Keynesian was, perhaps, the absence of any intertemporal considerations, intertemporal constraints of any sort, in the discussion. This is unusual on this side of the Atlantic.

The theme of anything I would say about both the current imbalances and about longer-term questions of growth would be the need to take explicit account of intertemporal constraints. It is quite difficult to disentangle what is going on within the industrial world: two sorts of things are happening in concert. One is clearly a set of imbalances that were generated by unwise government policies, perhaps to a large extent in the United States, which created international imbalances that are unsustainable. (Incidentally, because of the longer-term consequences, the intertemporal constraints, I wouldn't characterize the U.S. policies of late as a Keynesian success story.) We have got that sort of imbalance. The other sort of imbalance is something that we characterize as international imbalance, but at least in a large part, to my mind, it is intertemporal balance. Let me be more specific.

To the extent that in Japan, and to a lesser extent Germany, one can characterize high national savings ratios as being in part an anticipation of demographic trends, one can't possibly *characterize them as imbalances. If you save a lot now because of impending retirement, that is, intertemporally, an optimal decision; it is not an imbalance in any sense. Once you have saved a lot, the question is what to do with your savings. Now it would be wonderful if you found investment opportunities at home, but if it turns out that there are better investment opportunities in Korea or Taiwan or somewhere else in the world, it is in no sense an imbalance to put your savings into those countries and to run large current account surpluses. I would characterize that positively as an equilibrating economic phenomenon.*

So I would say that these are at least parts of the large surpluses we see in the surplus countries that aren't in any sense imbalances. They are an equilibrating process. Of course, disentangling that from the effects of the Reagan fiscal shock is awfully difficult. But what I would plead here is that we do try and disentangle them, and we distinguish real imbalances from optimal intertemporal decisions.

I was surprised at the characterization of growth as being driven chiefly by investment. I thought that long-term growth was explained, to a significant extent, by total factor productivity (which is a name for what we cannot explain by the contributions of capital and labor). And when you look at that in different periods, I would have thought we could attribute it to technology, to entrepreneurship or the growth of entrepreneurship, and to what the psychologists call hygiene factors, that is, the cleaning out of restrictive regulatory practices.

If it is correct that total factor productivity explains a large part of growth, I think you have attributed too much importance to investment and demand forces. But, more generally, if one thinks that growth will proceed over the longer-run by means of government-generated demand shocks, one has to ask: Where do you start from and where do you end up?

Policy Reforms...

If you start from very low budget deficits and very low government-debt-to-GNP ratios, you can rely on fiscal stimulus for quite a while. But if you start from anywhere like where we are now, how do you do it? We have situations in countries that we are marking as possible engines for growth, like Germany or like much of Europe, where government debt/GNP ratios are awfully high and are projected to increase further.

We have a situation where monetary stimulus is not effective because yield curves are already very steep: while governments can push down short-term interest rates, the long rates don't go down because of skepticism in the markets of the long-run impact of expansionary monetary policies. Moreover, it is the longer-term rates that influence the interest-sensitive components of demand.

So if you are starting from where we are now, I don't know how you can assign so large a role to the government. If you are starting from some position of a better relationship, better sort of stock relationship between government finances and the economy, then the critical question is: How do we get from here to there? But even if one starts there, can one characterize a steady state, which is driven entirely by government intervention? When we know that if government deficits grow larger, eventually we have a problem of the debt being so large that it exhausts the discretionary capacity for the government to operate fiscal policy.

Let me make one plug, though, for the sort of shock that I think can generate growth over the medium term, and it is something that Boltho downplays, and that is the "hygiene factors" shock, the getting rid of regulatory rigidities. I know that has been a term that has been thrown around rather loosely in the last few years. When we don't know what to do with macro policies, it is very popular to say that there must be something regulatory or structural we can change.

Japan and Germary

But I think there is more to it than that. In Japan, for example, if one looks at the agricultural sector and the interaction between land prices and construction activity, there is an enormous capacity for deregulation which would generate construction, boost home ownership and lift the standard of Japanese housing.

When one looks at Germany, what one sees is evidence of very high preference for leisure rather than consumption. Germany seems incapable of generating sustained growth on private domestic impulses. But there is also tremendous regulation of the non-traded goods' sector. Germans can't buy because shops are closed half the time. They can't have sales in shops; they can't have aggressive marketing in the retail sector because of outmoded restrictive regulations. The domestic land transportation sector is completely tied up by regulation. An elimination of these impediments would simply have to generate some capacity for additional investment, some dynamism.

This is the sort of government-generated stimulus which do not lead to steady state problems over the longer term and which could, I think, raise total factor productivity and growth potential.

Role of LDCs

<u>MR. RUSSO</u> I will continue on this same vein, and I think the paper of Andrea [Boltho] dismisses a bit lightly the question of the LDCs' role in deciding what is the appropriate pattern of present current account deficits and surpluses and what is a desirable surplus.

Japan and Germany have faced similar situations. High government debt creates constraints in some European countries. These countries are unwilling or unable to increase their debt and, therefore, they have to reduce their primary deficits and therefore the counterpart of that is perhaps in the external current account. There is also an intertemporal issue here.

With these considerations in mind, a desirable pattern of current accounts may well imply surpluses of Japan and Germany and smaller deficits of the United States but larger deficits of the LDCs. The fact that 70 percent of trade takes place within the OECD I don't think is sufficient consideration for setting the LDCs aside.

In addition, issues concerning the exchange rate regime and policy coordination are also very important. What we see now is international mistrust rather than coordination. Countries are not prepared to change their policies because they don't trust what the policies of the other are going to be and their effect. As a result we make agreements and declarations, which naturally are broken very quickly or are modified very quickly.

But unless we get to a judgment about what Mr. Lipschitz has underlined, i.e., what is the appropriate position both within the OECD and of the OECD vis-a-vis the LDCs, I find it very difficult that agreements can be sustained. And unfortunately, the political cycle is such that makes this agreement very difficult.

MR. PERRY: A number of interesting things have been said, and I want to comment on a couple of them. I would stress that the paper we are discussing is worth everybody's reading.

More on the Imbalances...

The idea of what has to come first is one that does concern this group, whether all of these so-called imbalances have to be settled before you can deal with growth. And I do think that is backwards. The imbalances are a product of stagnating economies and that, if you ask if there is any way out, you really need to get out of stagnation in order to deal with some of these imbalances.

It is also true that what constitutes an imbalance is a little ambiguous, and we tell the story whichever way it fits best. If some countries really need to save a lot, that is not an imbalance. If they want to consume in the next century, that is not an imbalance.

But we know that that isn't really what is going on. We know that the U.S. didn't deliberately set out to have the current account position it now has. It stumbled and fell into it out of ignorance not design. I don't think there is anybody who would make any other case for the position of the U.S. current account.

But, more importantly, some of the places where savings ought to go, places which in a world of capital mobility we would regard as having the highest potential for using that capital, are unable to borrow.

It would be highly productive in an economist's sense to have a lot more investment pouring into Latin America, and that can't be done for the obvious reasons under current arrangements.

So I don't think we can just sit back and say what we observe is what everyone intended or what is best. We do have to think of these things as problems that have arisen and ask what might help out. You need to have a lot of expansion in order to alleviate some of these financial problems that exist.

And the idea that you can talk about growth once you have dealt with financial problems really is backwards. It is an attitude and a point of view that can only worsen some of the issues that we are talking about.

Once again we know what will stimulate economies and what will slow them down. There are some barriers, I think they are self-inflicted barriers, that are probably relatively important in parts of Europe. I think of them mainly as barriers in the labor market and institutional arrangements that make expansion a little more difficult. I think even those are endogenous and would melt in the face of stronger expansion. So I am really siding with Boltho's conclusions.

Not only am I siding with him, but arguments to the contrary seem to be based on little or no evidence. At the risk of sounding a bit too simplistic, I think the direction in which everything has to go is clear. The political will is quite another matter, and I agree that Europe is in the midst of a political situation that makes nobody anxious to do the right thing. That doesn't mean that we shouldn't recognize it.

MR. O'BRIEN: Addressing directly the Boltho paper, I think there are two areas I would like to talk about. One is again a general discussion of imbalances, consequences of unwinding or not, and the role of cooperative behavior in that, and then also I would like to make some comment on where inflation fits into the whole thing, including its relationship with the imbalances.

It is clear that there are four areas where it is important how you unwind the imbalances. One is where you are going to start from, in terms of capacity utilization and unemployment, when the new growth starts, if it ever does. Secondly is what is actually done to the attitude to risk-taking and investment during a prolonged period of uncertainty. The third is the state of the world trading system, given the pressures for protection that the imbalances generate.

But fourth is the functioning of financial markets which are spending a long time worrying about short-term flows consequent or not knowing what is happening with the imbalances, and at the beginning of an upturn it would be nice if financial markets had some *training in thinking about the long-term rather than simply the short-term.*

Cooperative policy solutions...

As to whether there is a feasible route after the imbalances, I think it is worthwhile recalling where they came from, and that this relates to the possibility of having a cooperative solution, I think.

The imbalances come from imbalanced policies and the imbalanced policies come from differing views in different countries, partly about what are the underlying problems and partly about what the appropriate methods for dealing with them are, so that one has had over the last six, seven, eight years, a variety of policies.

Taking the example of what has happened from the end of 1986 onwards in terms of the apparent development of cooperation, it strikes me that this is actually being the development of occasionally sophisticated ways of hiding the fact that everybody actually disagrees on what they are meant to do, while producing statements to the effect that they agree.

Maybe a quicker way and a better way to resolve the imbalances would be to admit that cooperative solutions aren't going to work, because we don't actually agree on what the cooperative solution is, and, further, [policy-makers may eventually] let the exchange rate pattern take the consequences [because] of the underlying savings-investment imbalances.

And maybe, rather than a cooperative solution, [a major change] might then provide the system shock that Boltho is talking about, rather than trying to keep the current system going as long as possible on a cooperative basis.

I would also like to mention that I think the role of inflation and the possible danger of inflation in an eventual secular upturn may be understressed in Boltho's paper.

But will growth go beyond 2-1/2 percent towards the mid-1990s? If not, we will have unemployment remaining high and capacity utilization not increasing beyond the current levels. And although we have this low growth picture in the medium-term outlook, the inflation picture that is thought, by country experts within the OECD to be consistent with this unemployment outlook, is one in which inflation doesn't decelerate any further.

Inflation threat...

But why, despite such a high level of unemployment, is inflation not going down at a faster rate? Two explanations are possible among the many. One is the hysteresis argument, that the equilibrium (in the inflation sense) rate of unemployment follows the actual rate of unemployment around.

Another argument which was suggested to rationalize what we think has been happening and is going to happen in the inflation/unemployment relationship, is that somehow there is actually a floor, at the moment, to what wage inflation can be. Custom and practice say that wages will not grow by less than such and such, depending on the country, just because people have got used to high wage rate growth, from a period of prolonged high inflation; they think in terms of reducing wages to a particular level.

Those two rationalizations are attempts at interpreting recent history and our forecasts. But in terms of the revival of growth, they clearly have different implications, and particularly if hysteresis is the correct explanation or at least has more of the explanation contained in it, then any kind of increase in the rate of growth which is sufficient to reduce actual unemployment will increase inflation, and to return to a sustained level of relatively low unemployment will result in a permanently higher rate of inflation. Even if hysteresis works both ways, then the inflation rate ought to stabilize eventually, but it will be permanently higher.

On the other hand, if the floor argument is the correct way to interpret what is going on, that is perhaps a bit more optimistic. Inflation needn't rise until the floor ceases to be a binding constraint.

But although in that case one might characterize it as being more optimistic than the hysteresis argument, I think it is still a pessimistic view since it is saying that nothing has really changed however you characterize the inflation and growth trade-off. Nothing has really changed over the last period of recession from what we had before. None of the problems have been solved.

And I think this would bring us back to where the imbalances came from. I described the imbalances as coming from a confusion of policy responses. These responses were to economic stagnation. Where did the stagnation come from? Boltho discusses whether it was real wages, demand, a few other things, but really focussing on the former two kinds of alternatives. He suggests that while too high real wages might have something to do with the problem in the mid to late 1970s that most of it was due to relatively low aggregate demand growth.

Now it is my recollection that one of the more important reasons for that low aggregate demand growth was actually a response to a perceived wage problem, nominal wage growth perhaps, or the level of real wages. In other words, one could argue that the imbalances in part come from a structural inflation problem in the OECD economies.

PROF. BRADFORD: To summarize Professor Boltho's paper in a concise way so as to be able to make some remarks, the question, I guess, is: What does this longer-run historical perspective give us? And I think it gives us some useful insights.

I think the problem is when he gets down to what could be done that it is not clear to me that the longer-term perspective is so helpful. Basically what you examined, it seems to me, is a set of issues that had to do with: one, whether or not there were any physical capacity constraints to longer-term faster growth, and you came up with the conclusion that, no, there were no physical constraints.

Smooth transition from imbalances to long-term growth?

The longer-term perspective leads to, I think, a hopeful inquiry into whether or not it is possible to get what you called an ordinary or smooth transition from the current set of imbalances to a longer-run growth path and to explore positive system shocks as a mechanism for getting there and to meeting the kind of expectational investment-growth linkage that you find there.

I have some difficulties with that, because it seems to me that the nature of the world economy since 1973 at least is quite the contrary from what it had been prior to 1973. I think what we see is not a smooth path but rather, a sequence of disequilibria. In fact what you have is a kind of jolt to the system which sets up some disequilibrium forces, which have led to over-correction in a next phase, and on and on. So that rather than there being some conver-gence back to a smoother path, what you really have is eratic trends and more cycles.

During this period, despite all the academic fussings and debates about macroeconomics, there has been, as we all know, an extraordinary consensus, in analytical economics and internationally, about the one fundamental cause of world imbalances, namely the U.S. fiscal deficit. And what we see there is, I think, the place where the crucial capacity question comes to bear, and that physical constraints are not the dilemma. The real capacity constraint is a political one.

If you believe that the world economy since 1973 has some intrinsic and policy-induced sequences of disequilibria, and if you think that where we are short on capacity in the world economy today is on the political side, then the more logical conclusion to draw is that perhaps the way to change to a regime toward greater international coordination is not by some sort of positive policy whiplash, which doesn't seem to be in the offing, but rather by a negative system shock, namely a further downturn of sufficiently dramatic dimensions to induce a political change.

Otherwise, I think, the scenario that you paint, where you have actually assumed away the imbalances, one of long-term sluggish stagnation or stagflation, is perhaps the more likely scenario. But

I don't see us vaulting to higher growth from a positive regime change but rather from a negative downturn, and that inducing regime transformation.

MR. RAO: I am having some trouble understanding what exactly the system shock thesis is. I might put forward two alternative hypotheses or descriptions of it, and I wonder which one we are really talking about.

Systems shocks....

If one accepts the statement that in the 1950s and 1960s growth was somehow stimulated by some system shock -- and I see the definition of the system shock here as being more skillful macroeconomic management and Bretton Woods and all of that -- and now we see in recent years some sort of stagnation setting in. Are we observing the natural running down of the effect of any shock so that the present stagnation is simply the netural plateauing after the initial response to the stimulus provided by a shock? Alternatively, are we seeing the unwinding of the improvements that brought about the 1950s and the 1960s growth?

In this second interpretation, we are seeing not a shock and a plateauing, but rather an improved regime that had good results backsliding to a less appropriate or salubrious regime for international growth, and if that is the case -- then I think Professor Bradford's thesis is that a sort of negative shock might be what we are looking for. In other words, you sink so low, you hit rock bottom and then everyone is jolted in realizing how bad things can get and then say, well, you have got to do something about this, which is the sort of political shock that I think Professor Bradford was referring to.

So I would like to know which of these hypotheses one is talking about. My next question is: looking at [the assumption in Professor Boltho's paper], the data of GDP weights for 1965, 1985 and 2000, one sees developing country weights going from 16 percent in 1965 to 22 percent in 1985, but being projected to grow to 33 percent in 2000.

Now that, if it happens, would itself be a shock -- not just a shock in realizing that this is what is happening, but also a shock to the international system because surely, if developing countries go from 22 to 33 percent of world GDP (excluding Eastern Europe and USSR), they must be doing something to the international system which would constitute somewhat of a shock to the system.

PROF. BOLTHO: I can answer these questions and I can answer some points that have been raised in the discussion, particularly by Goran Ohlin and Leslie Lipschitz.

On what is the system shock, I haven't defined it myself. I am not quite sure there is a scale to either of the two interpretations you have put forward, though I suppose a mixture of the two might do.

Definition of system shock...

But specifically taking the positive shock of the 1950s, the international monetary system and domestic policies, why did they collapse? The simplistic explanation is: there were negative shocks, the two oil shocks in quick succession plus the shock of the mid-1980s, the big external payment imbalances developing. Surely that can counterbalance any positive policies.

But I think there is more to it than that in the sense that the success of the 1950s and 1960s was carrying the seeds of its own destruction in two ways: a domestic way, through acceleration of inflation and full employment together with conflicting claims, too ambitious policies, too much fine-tuning, hence an acceleration of inflation, which even if we hadn't had the oil shock would almost certainly have led us into a much more restrictive stance in late 1970s or early 1980s.

The second set of problems which the system was creating were international and financial in nature and led to the breaking up of Bretton Woods. This idea of the dollar remaining a reserve currency forever, nobody worrying about it, even though everybody was accumulating it was too good to last. Hence, both mainstays of the system were doomed from the start. Expansionary policies were going to have to give way to restrictive policies because of accelerating inflation. An international monetary system, which was thought to be very stable, had a strong potential for falling apart. In fact, it fell apart even before the oil shock because of the so-called Triffin inconsistency within it. To that were then added the effects of the two oil shocks and everything else.

The figures that Mr. Rao was referring to (i.e., a sharp increase in the share of developing countries in the world output by the year 2000) are purely illustrative. In no way was that meant to be a projection of likely growth rates. All I was trying to do was to show that, even under extremely favorable assumptions for the LDCs, to my mind it was unlikely that the LDCs would take over the role of major locomotive in the world economy. I was trying to defend my emphasis, the focus of my paper, which is entirely on the OECD countries.

I admit that actually if the LDCs did grow as rapidly as that, that could create some adjustment problems, possibly some favorable side effects for the world economy at large. Now if I may, just on the imbalances more generally, start off with one of the points Leslie Lipschitz made, which I don't treat in the paper, that is the idea of an intertemporal balance.

Intertemporal imbalances...

I would like to comment on four points that have actually been raised in connection with the issue of intertemporal imbalances. On the one hand, it is argued that the Germans and the Japanese, because of their respective characteristics, save a lot. It just happens that twenty years ago the Germans and the Japanese were saving as much, and possibly more, without probably really thinking about these demographic problems at the beginning of the next century or by the year 2020.

Thus the foresight implicit in this attitude I find somewhat far-fetched. But quite apart from that, are these positions really balanced ones? Leslie Lipschitz suggests that if the Japanese want to invest in Korea and Taiwan, well that is fine. But Korea and Taiwan save a lot themselves, and in fact, they have got current account surpluses. They happen to be putting it all in the United States. However, the US as a debtor country may not want it.

There is also a problem on the creditor's side because the Germans and the Japanese don't like the real exchange rate implications of their huge surpluses. Moreover, there is a problem of the allocation of these savings. Even if there was this intertemporal balance which one might want to maintain, then the money shouldn't be going to the United States; it should be going to the LDCs, but of course it won't. And crowning it all, there is this enormous exchange market uncertainty, which tends to be driven by day-to-day considerations.

Even if, in an ideal world, Japanese savings ought to be exported to Latin America, we are not in that ideal world; we are in the presence of major imbalances, whatever intertemporal shifting might lead one to expect.

Is it, therefore, inevitable that the next few years, 1989, 1990 will see a recession? And if we see a recession, will it be coupled with inflation, or will we at least be able to avoid one or the other of these two possibilities?

MR. LARSEN: I was very stimulated by Professor Boltho's conclusion that there seemed to be a consensus that the issue of the imbalances and their resolution are absolutely essential for the long-term outlook. But if you would allow me to be a little provocative, I think I would probably dissent to a degree, from that view.

Resolution of the imbalances and the long-term growth...

It is, of course, quite possible that the resolution of the imbalances ultimately might result in slowdown in growth. I don't think it is necessarily inevitable that it will. This is, of course, very difficult to judge, but I think a much more important question is: Will such a cyclical event, which I would consider it to be, necessarily affect the long-term growth path of the world economy, of the industrial countries or the developing countries?

And is the point where I am beginning to have some difficulties with the emphasis on the imbalances. That is, if we look at the very long-term growth trend, the possible growth path for the world economy, I really doubt that these imbalances and the resolution of them are all that important.

It is, of course, possible that the imbalances or their resolution might lead to some policy mistakes, particularly in the area of protectionism. If that were the case, I would definitely share the concern that this might reduce the potential rate of growth.

But otherwise, in the absence of such policy mistakes that could seriously interfere with the functioning of the markets across the world economy, I think at least it is useful to examine the hypothesis that the resolution of the imbalances might have only a short-term impact on growth. If you are looking at the average growth rate for the next three, four, five years, this is a very important factor to keep in mind, and it is important in its own right because it could seriously damage, for example, the management of the debt situation if growth in the industrial countries were to decline significantly for a couple of years. Going beyond that, however, I really doubt that it is all that important.

Now what then determines growth over the medium-term? We honestly do not know very much about it. And I think we have to be extremely careful in entertaining either too optimistic or too gloomy expectations.

Nevertheless, I cannot help feeling that I am very impressed by the empirical fact, as it is, which was also noted and stressed by Andrea Boltho in his introductory remarks, that there seems to be a secular growth trend which is not all that different from the growth rates we have been experiencing in the 1980s [in the industrial countries].

Now what exactly that means I would not be able to explain. But I cannot help but being very impressed by that observation. The question then arises, of course, why did we do so much better during the Golden Age, from the end of the World War II till about 1973?

I think the answer to our expectations for the medium-term or for the long-term future obviously must depend, to a very large extend, on the conclusion that one arrives at in examining the possible reasons for why we did so much better over those twenty to twenty-five years.

The catch-up hypothesis

Boltho has looked at a number of possible explanations. I think personally I would probably agree with most of the factors that have been mentioned, although I would perhaps attribute a larger weight to the question of the catch-up hypothesis, the process *whereby Japan and Europe gradually caught up with best practice technology, as it had evolved in the United States over the preceding thirty, forty years, together perhaps with the stimulus and the positive shock, in a sense, due to the combination of post-war reconstruction and the liberalization of international trade, the reduction of trade barriers.*

It is, of course, quite possible that the Keynesian consensus, as Boltho describes it, did also contribute. There were very high growth expectations. Governments actively sought to smooth out the cycle and to stimulate growth. But in examining and coming out with a hypothesis of the possible contribution of this Keynesian consensus, I would also take into account some of the problems that followed after the war. Expansionary fiscal policies perhaps were pursued a bit too long with the result that wage expectations became unrealistic relative to underlying productivity growth, with the result that wage earners, unions in many countries essentially forgot that they also had a kind of responsibility for what happened to real wages and thereby demand for labor.

To adjust these expectations again was obviously associated with enormous costs. So, in discussing and trying to measure the impact of the Keynesian consensus, there was probably a positive impact during those twenty-five years, but I would deduct from that some of the subsequent adjustment costs that were associated with adjusting expectations downward to a more sustainable level.

As a basis for looking ahead, given that I think it is not unreasonable to make the claim that there is not much more of a productivity gap to close between the major countries. I think it is safe to start out with the assumption that maybe the underlying secular trend, wherever it comes from, may have reasserted itself.

Raising growth relative to its trend...

And the question then becomes: Are there factors that would allow us, temporarily perhaps, to raise growth relative to this underlying trend of perhaps 2-1/2 to 3 percent -- are the factors that would allow us to raise growth relative to that or are there factors that would tend to suggest that growth might actually turn out to be weaker than this trend?

I believe that it is the positive factors which will emerge -- and it is mainly the positive factors you have been looking at -- I would agree with most of what Boltho has said and what he has written in his interesting paper. But I would also very much emphasize the possible gains that might arise from further trade liberalization, particularly in the area of agricultural policies. This could provide a significant boost to potential upward growth in Japan, in Europe and in the United States.

I would also, in general, emphasize the contribution of micro policies to structural reforms, although it is hard to quantify or measure them.

One example of how this could influence and stimulate growth is, of course, in the area of labor markets. It is important to distinguish between the kind of policies that might stimulate the underlying growth path, raise total factor productivity and policies that could help us to better absorb some of the under-utilized resources in the labor market.

That is, create some kind of level shifts if labor markets began to function better, which presumably would be associated with low inflation, and would allow policies to become if not more expansionary then, certainly in many countries, become less restrictive. So while this may not, over a longer period, raise the underlying growth rate, I think it might temporarily allow us to grow at a faster rate than the underlying potential rate of growth.

demographic factors...

However, it is very important also to look at the other side of that coin, the opposite side. I think there are some uncertainties and risks. And just to mention a few, I think, for example, that there is a major risk that we underestimate the pressure on consumption and, therefore, the potential impact on the aggregate investment ratios in the industrial countries, and to some extent also in developing countries. Although for other reasons, because of demographic developments, in the industrial countries linked to the aging of populations, this is going to become a very critical factor in determining how the overall pie is being shared and therefore how much of aggregate income will be invested in the future.

And if there were no other factor, I would definitely say that in the case of Japan, this would clearly suggest that the aggregate savings ratio and investment ratio and therefore, potential growth rate necessarily would have to be reduced in the future relative to what was experience in the 1950s and 1960s.

Environmental damage...

Likewise, the one area where I believe a lot of research is necessary and probably will be done in coming years is the question of how the environmental constraint is going to affect the productivity of capital. How large a share of new investment in the years ahead will be reserved, so to speak, to try to limit the degree of further environmental damage.

There may well be other reasons to be concerned that we may not even be able to maintain this underlying long-term secular growth trend in the future.

MR. BANETH: *Growth is like a bicycle. If it slows down too much, it may fall. And I personally believe that because of both political and social restraints, as you fall below or try to stay at 2.5 percent, the long-term outcome may in fact be much slower growth.*

The Triffin paradox...

I would like to come back to a couple of issues. One of them is the broadening of the Triffin paradox Andrea Boltho referred to; what is its impact on the slowdown? And how does one resolve the current disequilibria?

By broadening, I mean very roughly that what Triffin said is that the dollar exchange system was not tenable because it was built on the accumulation of deficits of one country, and at some point the financing of that would stop.

But the desire for surpluses has not necessarily stopped. The problem was sort of circumvented in the 1970s by the developing countries becoming suddenly very desirable borrowers. Everybody at the time agreed that they were creditworthy, but we know how that ended. To some extent in the 1980s the U.S. came back and played the same role, but who can play the role now?

Sustainability of the payments imbalances...

If the surplus countries argue, in a sense, that disequilibrium is desirable -- which is to some extent normal partly because of the aging of populations and partly for other reasons -- that to some extent, surpluses are desirable, how can one find corresponding solvable deficits, deficits which make this situation tenable?

If it is in fact tenable, what is the financing innovation, the financing mechanism which will allow us to go on in the medium-run, without reducing the deficit?

The question is: How do we render this current situation sustainable, either by building up the financial means of maintaining the same deficits, or by reducing the imbalances, or by a combination of the two? And what are the implications of this for long-term growth in general? I see a common thread in the various statements. That is that the mounting of inflationary pressures through structural changes (possibly generated by the Keynesian consensus) in fact prevent the application of sufficiently stimulative macroeconomic policies, or pushes towards more restrictive macroeconomic policies. What are the relations of this to the unwinding of deficits?

MR. ARMINGTON: *I would just add a footnote that perhaps there is a golden rule lurking in the woodwork here -- a 2-1/2 percent solution for growth. We just didn't do enough work on economic history to appreciate that ten years ago.*

the 2-1/2 percent solution...

But just to throw out a question about that: it is true that there was a reasonable consensus, ten years ago, that the growth trend of industrial countries was at least 3-1/2 percent. For example, the 1979 World Development Report was not outside the range of commonly-discussed estimates at that time, projecting an average growth rate in the 1980s of 3-1/2 percent to 4-1/4 percent. Now we *are talking about a full percentage point less than that, as the perceived underlying trend for the future.*

Were we just too optimistic at that time about technical progress? (We were probably not that far wrong on population growth.) Or are we now being too pessimistic?

MR. PERRY: *What do we do about some of these imbalance issues on the realistic assumption that growth alone doesn't get us out of them?*

More on the imbalances...

The overhang of the dollar is another imbalance, and it is also a very serious problem. It inhibits investment a great deal to have the kind of currency instabilities that we have had. I think that we have had an experiment which has failed, basically, and it has failed because the dollar went up much too high, and then it threatened to go down too low.

If you look at what is happening to investment, just "prospects" for conducting normal expansions, this currency instability has turned out to be a serious problem.

The initiative that ought to be taken over the medium-run has to do with finding a new way of dealing with exchange rates other than the experiment we have had. We need a more realistic answer than hoping for more government cooperation, which is sort of a medium-run hope presented in the paper by Boltho.

But there is a short-term answer, which is attempting to stabilize the dollar at the present level. It would probably be constructive and ought to be successful and ought not to involve perverse policies on the part of the U.S.

We are just beginning that experiment in stabilization and, anywhere around present exchange rates, the markets will cooperate if governments will convince them. They are determined. Markets are not closely bounded by fundamentals, and when we economists try to model this thing as though there are fundamentals and you can't fight them, we miss the point, which is that neither we nor the market can estimate such fundamentals well at all.

All the markets are chasing is what is going to happen next month. It is not really hard to convince them that what is going to happen next month is a stable dollar. Doing that would be a genuinely constructive step to take in the present context.

If you can establish that, I think you can look forward to both lower real interest rates and better investment prospects. If the instability that we have seen in exchange markets continues, because what I am suggesting isn't pursued vigorously enough to succeed, then things like a collapse of equity markets, and ongoing *reluctance about investing, are likely to continue to plague us. The calamity scenario runs off of currency instability at this moment of time.*

MR. LIPSCHITZ: *I would like to comment on some of the points made.*

I think Perry is exaggerating a bit in saying there is no evidence against the view that demand stimulus could solve our problems. It seems there is a mountain of evidence in the literature on why unemployment is high, trying to separate classical from Keynesian aspects of the present unemployment problem.

debt/GNP ratios...

On the other questions raised: First, on fiscal stimulus in Europe, why should it be that debt/GNP ratios or fiscal positions of the sort we have in the United States now, give rise to alarm, but similar ratios for Germany, for the Netherlands, for the Scandinavian countries, do not give rise to alarm?

Policy coordination...

On monetary policy, anyone who has looked at what has happened over the last five years must be skeptical about the choices of monetary policy pushing us out of slow growth. We know in Europe that it is the long-term interest rates that affect interest-sensitive components of demand. We have seen central banks push down short-term rates and the long-term rates rise or stay constant in response. This indicates skepticism on the part of markets.

The broad question that has been raised, is how we set up a system of policy coordination that will work. What are the gains from coordination? In the last few years, we have witnessed a great deal of optimism on coordination slowly give way to somewhat less sanguine expectations about the gains from a coordinated effort at exchange rate stabilization.

Clearly, attempts at stabilizing the dollar in the way George Perry suggested, haven't worked very well at all times. In most instances markets just haven't found policies credible.

But one of the problems might well be that Americans understand very little of the problems of Europe and are not persuasive in talking about Europe, and I suspect vice-versa; that sometimes when one listens to this debate, it sounds like a dialogue of the deaf.

On the question of the system per se, of course there is a wealth of literature on how we should set up a new monetary system, literature around the EMS question, work by Ron McKinnon on a new fixed-exchange-rate system with symmetric policy responses so that the U.S. doesn't have a free ride.

The problem with a lot of that literature is that it has dealt exclusively with financial shocks rather than real shocks. What work there has been on policy coordination in the face of real shocks is, I am afraid, still at a rather primitive stage.

PART II

(Afternoon Session: 2:30 p.m.)

MR. BANETH: I would like Mr. Steve Marris to continue his analysis [that he started during lunch] of slightly gloomy short-run to the buoyant medium/longer-run outlook for the world economy.

MR. MARRIS: Let me try to look beyond the hard landing. This is something I am starting to try and think about. You always need to be counter-cyclical in our business. So my next book is probably going to be about the dangers of the dollar going up too soon and too much!

Inflationary recession in the United States...

But taking up where I left off I believe that the beginnings of an inflationary recession in the United States are inevitable. What exactly is the timing I am not sure, and this recession, of course, is an unusual recession for the United States because it is externally generated. That means that there are three things which are completely out of line with NBER cyclical indicator approach to recessions.

The recession starts with interest rates going up rather than going down. It starts with inflation staying up or going up rather than coming down. On the other hand, it also has built into it a very strong boost to the economy coming from the lower dollar.

Dow Jones to "1000" plus something...

Long-term rates will rise...

The configuration that it points to is a recession, which in the financial markets of the world starts looking rather horrible. It is generated, in fact, by financial phenomena. The Dow Jones goes down to "1,000" or so. Interest rates peak, go up. The long term rate, I maintain, will go up to 12 or 13 percent, and this incredible euphoria in which this country [the United States] has been living for quite a while will blow up.

But precisely because the whole thing is unrolling fairly slowly and because the dollar has already been down far enough for long enough to be giving a strong boost, we are now getting anywhere between 1/2 to 1 percent of GNP per annum improvement in real terms in the external balance, and I think it's absolutely inevitable that it will continue for another two to three years.

The recession may start as a sharp one and look rather nasty, but it will be short-lived. And then we get to the feedback onto the political scene.

U.S. budget deficit will be eliminated...

I am confidently predicting that the U.S. budget deficit will be eliminated within the next -- I mean, action will be taken which will lead to the elimination of the U.S. budget deficit --

18 months to three years, because the market will demand a policy change: with the Dow Jones at "1,000" and interest rates up, the deficit will have to be eliminated.

So part of my scenario is that (a) we will have a recession in the United States; and (b) that the natural forces are such that there is a potential for a strong recovery, and that eventually is consolidated by exactly the Thatcher phenomena, i.e. that a convincing package of budget cuts by enabling one to sort of stabilize the dollar, get down interest rates and generally convince people that what is wrong is being fixed; this will lead, in fact, to a strong recovery in the United States.

So within a time horizon of two years out [1990-1991], I am really rather optimistic about the U.S. I think that the U.S. economy is indeed still a very flexible and dynamic economy, which is being remarkably borne out by what is happening in the manufacturing sector. In particular, I find remarkable the speed of the swing-around in that sector.

Now having said that, there is in my view one enormous sort of Damocles hanging over the U.S. economy. A recession is going to do wonders for the trade balance. If you go back and look in my book [Deficits and the Dollar: The World Economy at Risk], you will find that in the "hard-landing" scenario in which the dollar goes down not very much more from where it is now, and there is a relatively mild U.S. recession, the U.S. trade current account goes from minus 150 to plus 50 in the space of three years, and that is with perfectly ordinary elasticities in the model.

And, in fact, I think that is an underestimate. Part of that result is, of course, because imports are so much higher than exports before the recession. But the other thing is that I am convinced that none of our models take into account the interreaction between price elasticities and income elasticities. You know, what every other country has learned is that if you combine an undervalued exchange rate with a recession, miracles happen. I mean, they happened in Brazil; they happened in Mexico; they used to happen from time to time in France. And I think there is every likelihood that they could happen in the U.S.

Fluctuation of exchange rates...

So the really frightening thought is that somewhere out there, 18 months to 2 years from now perhaps, the dollar is going to start shooting up. Just remember that the dollar was still at its trough in the third quarter of 1980 and it went up against the Deutsche Mark by about 40 percent in the next 12 months. And within 12 months the forecasts by the foreign exchange markets were that the dollar was going to go down. In other words, within 12 months people thought the dollar had gone up too far, or at least it was not far off the level at which it should have been.

And it can move unbelievably fast. There are people all over the world waiting to buy up America. And when the trade deficit has gone down -- [although not in the beginning - but at some point, it will] -- by a half or when it suddenly gets to zero, money is going to come pouring in from all over the world into the U.S.

And that, in my view, if we now want to get to the transition from the short-run into the medium run, is the crucial linking policy issue, because I think there is a very serious risk that the dollar will go up too soon and too much. and, in other words, the dollar will not stay down long enough at a sensible level to really reindustrialize America and reestablish a basis for the dollar as the world's currency and for the United States' economy as a sort of linchpin of the world economy.

I suppose, what we need is a crisis serious enough to actually be able to find a moment where we can lock the governments into a better managed exchange rate system, but not so serious that the whole thing breaks down and there is nothing left to manage.

And the story there is absolutely open. I don't think we know what the end of that story is. But I think that it is, in terms of the longer-run of the world economy, a key one, because if I now move outside the United States the most encouraging thing is the way Japan has been able to turn potential domestic demand into actual domestic demand. And it is really becoming quite dramatic.

Yen could rise to 80?...

And we have this picture of Japan and the whole of Southeast Asia in really very good shape. So that is one strong point in the world economy. I still think that the Yen at some point could rise to 80 [against the dollar] but the Japanese have shown their pragmatic attitudes to all these things. [They have taken a leaf out of Mrs. Thatcher's book.] And if they use all these proceeds from NTT to just simply boost demand, that is quite a lot of demand they can give themselves over the next year or two. So, they may pull through, and that means that the whole of Southeast Asia is all right.

If we come to Latin America and the desert countries, my all too simplified view is this: The debt crisis was caused by three things -- high U.S. interest rates, a recession in the North, and a strong dollar. What is now going to hit them is a blip in U.S. interest rates, but that will not last very long, because once the U.S. economy is clearly in recession, U.S. interest rates will come down. And looking further ahead, if something is done with the budget deficit, not only will U.S. interest rates come down, but we might get back to a sensible level of U.S. real interest rates by the beginning of the next decade.

There is going to be a recession in the North, but the U.S. economy is going to have to start to grow well within two years, and *that is the most important market for [the debtor] countries. Of course, in the longer-run, it is always the good thing for a debtor country to see a depreciation in the currency of its creditor.*

The debt calculus...

And if you do any of the debt calculus, with the dollar where it is now, there is a cash flow problem in the short-run with a recession and temporary blip in U.S. interest rates, but if you go out to the recovery phase, you will find that all the debt indicators for the largest debtor countries are back where they were before the crisis started; they are back to mid-1970s levels in terms of debt/ export ratios and so on.

Disequilibrium within Europe...

That leads me to Europe, and there I think is a very interesting story. I suggest to you that there is as big and as dangerous a disequilibrium within Europe as there has been between the U.S. and the rest of the world.

When we had the meeting of the Group of 33, I had the impression that some part of the improvement in the German trade position was not due to U.S. but was due to the rest of Europe. [I asked if anybody in the room could to give an estimate of how much the improvement in the German trade balance had been, at the expense of the rest of Europe.] Somebody who has followed the figures fairly regularly, said, "Oh, yes, you are quite right; it must be something like at least 25 to 30 percent. Which is roughly the sort of idea I had in my mind.

The German trade surplus...

[I then went back and got the figures:] Researching the figures, it showed from 1983 to the first half of 1987 nearly 80 percent of the improvement in the German trade balance was at the expense of the rest of Europe. That is equivalent to nearly one percent of the GNP of the rest of Europe.

Use a foreign trade multiplier of two, and you have [up to 1988] a break on growth in the rest of Europe, coming from Germany, of the order of two percent of GNP.

The time trend of this is interesting. This really only started after the dollar started going down, and it has been accelerating ever since, because in fact the EMS has been shielding the Deutsche Mark and it has been pulling up all the other currencies. The other European economies have also, curiously enough, because of the defense provided by the EMS, been able to grow faster than Germany. So we had this amusing situation of four locomotives of Europe -- Portugal, Spain, Italy and the United Kingdom. [Anybody knows that that can't last very long.]

I was very glad to see that our colleagues at the OECD had picked this up in their latest outlook [December 1987], and they have put in the figures I didn't have, which show that if you split Europe into Germany and the rest, the rest of Europe struggled into a small *current account surplus in 1987, when the United States was running a current account deficit of $160 billion.*

And that even in the OECD's projection, which has a fairly modest improvement in the U.S. current balance -- I think it comes down to $110 billion by 1989 -- by that time Germany is still running a large surplus and the rest of Europe is in very substantial deficit.

Germany and the EMS...

[It should be noted that] Germany, via the EMS, in my view, exerted a very valuable deflationary or anti-inflationary effect on Europe, in the first half of the 1980s. I think it was necessary, and it did indeed work. The EMS at that point was a vehicle through which the Bundesbank imposed anti-inflationary discipline on the rest of Europe, and that was probably what was needed.

From the moment that the dollar [started to go] down, [the situation] has turned around. The EMS has been a mechanism which has been shielding Germany from the consequences of its extremely cautious economic policies and, of course, what this means is that, if Germany really wishes [it could] go on with low growth, and its generally pessimistic view about its demographic position and everything else. That is its own right. But the issue of whether the rest of Europe is prepared to do the same I think is now becoming rapidly a central issue.

In fact, 1988-89 may be [the period] in which it is Europe that suddenly emerges as one of the major stress points in the world economy, unless Germany begins to grow at a faster pace.

It seems to me that it is very clear now that we have this massive disequilibrium within Europe. And the question is: How long can Germany go on like this? And what happens when the rest of Europe reaches the end of its tether?

MR. BANETH: How does the unwinding of the U.S. deficit come about as long as you don't have the unwinding of the surplus in Europe (Germany)?

Dollar, DM and Yen...

MR. MARRIS: There are two things. If you look at German economic policy over the last few months (latter part of 1987 and early 1988), it has been directed exclusively at trying to maintain the EMS. And indeed they have made concessions to the French in operating their interest rate policy and so on, because the only thing which will change German policy is the breakdown of the EMS.

And equally, it seems to me, the only way in which a significant reduction of the U.S. deficit can come about, without leading to a real mess-up in Europe, is through at least a 15 percent *appreciation of the Deutsche Mark (DM) against the other European currencies, even if the Germans were to take a more expansionary action.*

There is a gridlock of political and economic bottlenecks there, which it seems to me are bound to blow up once the current nominal value of the U.S. current deficit begins to fall at the same rate as the real one.

MR. ARMINGTON: That also probably implies a fairly large appreciation of the DM against the dollar. I mean the breakdown of the EMS is not just going to change currencies within Europe, but the DM is going to be exposed as the key undervalued currency.

MR. MARRIS: The Yen, of course, was fully exposed, and the effective Yen has gone up probably nearly 35 percent by early 1988, whereas the trade weighted DM went up about 10 or 12 percent, because it was living off the rest of Europe.

MR. BANETH: I find there is a bit of inconsistency between your rather optimistic prediction about the unwinding of the U.S. deficit, and your pessimism concerning the unwinding of the corresponding German surplus. How would the developing countries get out of (if only they survive) "the 500 degree heat of the furnace" for a couple of years.

Again, I don't think that is fully consistent with some of the rest of the story, including the impact of the likely rebound of the U.S. dollar, and the likely slowdown in growth and corresponding impact on primary commodity prices.

MR. MARRIS: Unless something is done to stop the dollar rebounding, then we are in trouble. If something is done to stop the dollar rebounding, [I still would say that I think] the conditions for a decade of four percent growth in the world economy, in the industrial economies, a new "golden period", not necessarily as long, are very good. I think the general underlying conditions for resumed fast growth in the world economy are excellent.

The main reason I ended with that digression on Europe is that the question of whether it can be done without Europe somehow putting its act together is relevant; well I am not sure. Europe is four times more important as an importer of commodities than the United States. It is particularly important in a set of triangular trade relations with the developing countries, convinced that I could put together my optimistic scenario for the '90s without assuming that somehow or other, at the end of the line, the Europeans *straighten out their mess. And, you know, I am much less optimistic [about that than I am about the U.S.]*

MR. BANETH: I think this leads us back to some of the questions which were opened earlier: In particular about Professor Boltho's assumption on the endogeneity of technical change, or the absence of a problem in technologies.

MR. OHLIN: Could I perhaps say just a few words about why I think this might be important for the 1990s.

What will be of importance in the 1990s?

What I have in mind is that there are certain important analogies with the 1920s and the 1930s in the magnitude and the extent of structural change, and the sectoral differences in manufacturing, and the whole high-tech business, the difference between high-tech and smokestack industries.

The reason why I thought it was worthwhile bringing this question up was that we are all aware of the pervasive importance of the electronic technological revolution. It affects everything. There is no point in looking just at the high-tech industry itself because it has a productivity enhancing effect elsewhere.

And the point about this Schumpeterian perspective which I briefly referred earlier, is that, after this period in which new technology slows things down or displaces more jobs than it creates, when that whole process of absorption is over, you come back to the productivity enhancing effect of technological growth. And this is after all the whole point.

Benefits of technological change...

So on that view briefly sketched of the 1990s, the benefits of technological change in the 1980s are reaped in the 1990s essentially, i.e. they are not reaped right away. It takes some time to absorb them.

If you look at industry after industry, you find an enormous retooling, obsolete technologies, also the capital equipment being replaced with modern electronically-guided equipment and so forth, and it is very similar to the whole thing in the 1920s, which was referred to as structural rationalization and so forth. The merger business is also part of that, the tremendous reshaping of the organizational structure of important branches, a new pattern of concentration, new companies taking over and so forth.

I think there is evidence of this kind, but it is obviously not easily measured. You have to take a different kind of view from that which one can do with simply active statistics.

MR. VERSLUYSEN: I have a question on this impact of technology. It was mentioned that there is a new pattern of concentration in industry. I thought that the main beneficial impact of micro-computer technology in the 1980s was to enable firms to reap the benefits of increasing returns to scale without having to have a large-scale industry.

If you look at a lot of statistics, particularly in Japan, but I think also in the U.S., the momentum for the increase of employment in industry has in fact been in small companies. This may diminish the volatility of employment. Unemployment will continue to increase in the major smokestack industries, but will be partly offset by modernized new small enterprises. The increments in production come from small companies.

MR. MARRIS: I think the one thing I am impressed by is that the electronic technological revolution is, it seems to me, the nicest one we have ever had. It is so general. It is both product innovation and process innovation. It can be used anywhere. It has this characteristic which is that it can stimulate competition and decentralization. You know, it is not like most of the big driving forces which would displace geographically -- where people have to shift from agriculture to industry or move from Europe to America.

It seems to me we are on the leaf of the lucky with this one, and, as long as we keep the world going at a reasonable pace, this one will work out extremely well, and probably be pretty highly productive.

MR. ARMINGTON: If we do wind up with, say, 2.5 percent growth characterizing the whole of the 1980s, that performance, in retrospect, may turn out to be considerably better than we would have expected without reference to a technological foundation for it. In the 1980s, the demand side, the policy side, and the monetary side have not been conducive to growth. Given that, the question is how did we manage to do as well as 2.5 percent, if this is near our view of the long-term growth trend for the future?

It may be that we will wind up looking for some difficult-to-measure reason why we managed to get as much as 2.5 percent annual growth in the 1980s, and hence come back to the technological revolution as a supportive factor. If so, well, then, of course, there is a potential for 3.5 percent, or even 4 percent growth in the 1990s, if you can get through some of the problems that Mr. Marris is talking about.

More on technology...

MR. LINN: How much of a normative dimension is there to the discussion of technology? I am a bit worried that it doesn't *get us anywhere in terms of informing what should be done in the next two or three years [1988-1990] in terms of policy, because I suspect that policy prescriptions for the next two or three years or even outer years are going to be pretty much the same, whatever we believe is in fact on technological opportunities.*

Successful technology policies, whatever they are, may jack up our estimates of potential growth rates by 1/2 percent, maybe even 1 percent in other outer years, but my impression is it is not a very fruitful ground for policy discussion. Would that be a biased view? What can we do in terms of a policy perspective?

The best thing we can probably do is to make sure investment takes place so that new technology gets embodied. And that means that we have to somehow crank up investment, bring interest rates down. Incidentally, that is a general question I would like to discuss in the long-term outlook, what happens to interest rates, real interest rates, which is not something that Boltho really looks at [in his paper]. But that may in fact be one of the crucial policy variables that affect technological absorption and implementation.

MR. BANETH: I think the policy implications are indirect, and we are not going to discuss very much how one would promote technological change or its embodiment except through investment.

But very much in the background and indeed in the forefront of German reluctance, up to now, to stimulate the economy is, at least at the verbal level, the argument that "we are close to, or indeed above, our potential growth rate." And if you want to work that further, it has to imply the lack of available technology to embody in the capital. You have no increase in the labor supply, and basically you can have a 1.5 percent per annum productivity increase because, no matter how much investment you have, that's about all the technological change you can embody in it.

Conversely, if there is a general feeling that in fact you do have the technology available for embodying into capital, which is not yet embodied, you can have faster change, and this removes one constraint on policy. One could then have faster growth without inflation. Indeed, if you do have these autonomous pressures on wages, if wages are marching forward at a certain rate, then you might in fact have a negative tradeoff between growth and inflation, if the technology is available.

Structural change...

MR. OHLIN: There are two points. I think the negative one is the rapidity of the thing. The acceleration of structural changes, the rapidity or the acceleration of structural changes in the 1970s and 1980s, for that matter you can go back almost to the *end of the 1960s, give rise everywhere to policies which ostensibly were meant to promote this. Industrial policy was the name of the game for a long time, and that turned into, in most cases, devices for actually slowing down structural change, from trying to promote and beef up the sectors that were threatened. And we know what excesses of subsidies that led to. So structural change was actually slowed down rather than stepped up.*

The other point which is related to this is the question of what happens to this process of structural change with the kind of exchange rate fluctuations that we have had and the misalignment phenomenon that has been talked about so much.

Well, we know that people closed down capacity in the U.S. in the days of the high dollar, and the question of the costs of this kind of premature adjustment to a level (which turns out, a few years ago, to be totally unrealistic) does raise some very serious questions of cost-benefit for the adjustment of capacity and the appraisal of competitiveness and so forth. You don't know what you are adjusting to.

PROFESSOR BOLTHO: I will try to reply to some of the points on the longer-run growth issue starting with Mr. Ohlin's comments.

Determinants of long-run growth...

The growth process is very complicated; there are a number of ("N") factors at work that determine the long-run growth rates of industrialized economies. But if "N" were a very large number, would we cross our arms and forget about it?

That is why I was trying -- as I have done in my paper -- to be perhaps assertive by stressing the role of investment, and I am going to stick to my view, partly because I am not just looking at 150 years of growth; I am trying to look at periods of acceleration, during which some of those forces which Goran Ohlin mentioned I don't think played that much of a role. That is particularly true of the sort of micro policies, the human capital, the efficient administration, which are a common feature, more or less a common feature of all the economies I am looking at, a feature which has progressed steadily through time.

Such a fairly steady movement which can't explain sudden decelerations or accelerations. There must be something else at play there. That something else could indeed be technology a la Schumpeter. There I think it is a question of how one interprets the evidence.

My reading of the evidence does not suggest that there are such non-linearities in technology. There may be inventions but not in adaptation of technology.

I don't think technology is a sort of permanent two percent trend or "N" percent trend which never changes. I think it is very closely linked to the business cycle (i.e. the absorption of technology into the economy). So it is not exogenously given in the way neo-classical theory would assume. But at the same time, it is not something that varies very sharply because of factors other than the cycle.

So I still have got to find something, and this something, in my case, is investment. This then brings me to future growth, and to Flemming Larsen's point that perhaps 2.5 percent per annum, is the underlying long-term trend. You know, we have had it for 150 years with the exception of 20 years; we will be stuck with it forever.

That to me is far too fatalistic. It may turn out to be true, but I don't think there is any particular reason why 2.5 percent growth should be the norm for industrialized countries.

What could improve on that performance? Steve Marris sounded much more optimistic than I actually would have sounded, and he is talking, I presume, about 4 percent some time in the next decade.

What could bring us to such a higher growth rate? The only thing that the Fund has to recommend, as both Flemming Larsen and Leslie Lipschitz have been saying, is policies of deregulation. That is the one thing which they seem to consider could bring about the expected acceleration in growth.

Frankly, I am far from convinced. For one thing, the 1950s and the 1960s were almost certainly a period in which regulations increased, in which the Welfare State became more "oppressive"; in which labor legislation got more binding. Yet our growth went on and on and on, apparently unperturbed by [these events]. What I am not saying is that it doesn't look as if these micro distortions were quite as important as people tried to make them out to be.

I don't want to say that if one reforms agricultural policies in Japan or Europe or America, that won't be a good thing. On the contrary such reforms may bring about a host of benefits to the industrial countries. But we can't quantify this and in my opinion their contribution to the growth performance is perhaps not that significant.

On the other hand, if you want, the one particular deregulation which has just been mentioned has had extremely serious negative consequences for our growth performance. I am thinking of deregulated [foreign] exchange markets. We have now got floating exchange rates which go up and down all over the place in real terms and they generate the negative effects on investment and on the tradable sector, which Steve Marris was just mentioning.

So there may be some forward steps that one can make in the deregulation area, but it really has been put at the forefront of policy concerns to a totally unwarranted degree.

What to my mind would be much more important -- and there I join Steve Marris -- and by far the most successful transition, is one in which we come out of the present imbalances with a different international monetary system which has a much greater degree of stability in exchange rates, and combine that with some growth stimulus from the fiscal policy side of a concerted kind. This may regenerate those more optimistic expectations which to my mind, even if they are not an explanation of long-term growth for two centuries, are definitely an explanation for specific episodes of acceleration or for that matter deceleration.

MR. MARRIS: *Basically I very much agree with Andrea Boltho that we are not going to get self-levitating growth, that somehow you have got to have demand and have optimistic expectations about the future growth of demand. That I think is crucial.*

The "liberal" market economy...

What I feel is that we are still in a too industriocentric view of the world, that the really important things that have happened in the realm of ideas over the last ten, fifteen years has been in the developing parts of the world. [These countries] have learned a great deal about the necessary types of economic policies to produce development. There has been an absolutely astonishing revolution or export of the liberal market economy to just about every country in the world, including even the Soviet Union, although that will take time.

Now the one thing we know is that in those parts of the world, you only have to get things half right. I have always said this: If you put a national frontier around almost any piece of the earth, whether it has natural resources or not, if you then put in it a population that is poor and starving, has some minimum of education, and provide it with some degree of political stability and a sensible sort of "liberal" market economy outlook, you have a miracle. I mean, every time, it has been done, it has produced a miracle.

I think probably "liberal" is the wrong word. Nevertheless, freer markets seem to be leading to democracy too, which is even more surprising, and that may be in fact the weakness, because maybe the democracies will blow up. But it is the economic policy that relies on getting both the key macroeconomic and the key microeconomic prices right. And we get miracles -- even if we can only achieve 2.5 percent growth in the industrialized countries.

WP/BOLTHO/SF:lg

I would like to pursue this issue of the feedback; of the importance of the developing economies for the industrial economies.

Feedback from the LDCs...

First we have the small, medium-sized economies which in effect are industrial countries except by classification. That is Korea, Taiwan, Hong Kong, Singapore are industrial countries by every criterion except the fact that they weren't there ten years ago.

And, indeed, once you put them in the industrial countries and you look at the industrial countries' growth performance in the 1980s, you will find a slightly different number, not terribly different because, as industrial countries go, these are still not very large economies.

Then you have the macroeconomies, India and China, where half the population of the developing world are doing reasonably well. But their connections to the rest of the world, I think, are not very strong. They are not very strong in the financial sense or in terms of international trade. Nevertheless, there are some connections and feedbacks.

Diversity within the LDCs...

Then I think we have a very heterogenous group of all the rest, which in weight is dominated by the highly-indebted countries -- simply because you have to be a fairly large economy to become highly indebted. Now what is the feedback we are expecting from these various groups in the rest of the decade, in the 1990s?

PROFESSOR BOLTHO: Well, partly in response to Steve Marris: sure, there is a lot of world out there. But there aren't a lot of miracles. There are a few miracles in some countries which are doing very well, and a few which are doing reasonably well. An awful lot of them are not doing well at all. And I wouldn't necessarily draw that simple parallelism between export or market-oriented policies and success.

Export-oriented economies...

The cases which have often been looked at, South Korea and Taiwan, show now that there is a certain amount of market orientation, but in the 1950s and 1960s there was very little trace of it. It was much more a Japanese type, highly interventionist strategy that was being followed. And conversely, you can take much more market-oriented economies like several in Latin America -- Argentina and Chile -- and they are hardly miracle stories.

I am not denying that in certain circumstances, market orientation can do the trick and certain deregulations can help, but I don't think it is a blanket recommendation that can be made to everybody.

In any case, quite a lot of these success stories have been export-led. Well, that is a well-known old argument now. Can every-

body be export-led vis-a-vis, basically, the United States? It has been the United States which has been sucking-in the imports, which again leads me to the feedback issue.

These countries, the really successful ones, have grown in the 1980s mainly because of the U.S. Can they change their growth pattern to something much more domestically determined? I see no trace of it in any of the smaller very successful countries. And, therefore, I find it difficult to see them [having an impact on the North.]

Japan is beginning to do it. Japan benefitted from the rest of the world for a very long time. It is now beginning to provide a feedback, mainly via the LDCs, directly, and also for Europe or America.

So I would be skeptical about the feedbacks from the small very successful ones. The large and the reasonably successful ones, as Steve Marris says, are autarchic, particularly China, which is both the largest and among the most successful.

There again, the feedback seems very limited. The ones which are much more open and less successful, what feedback can expect from them? Unless they can generate a self-sustained domestic growth process -- there again perhaps the only other possible country would be Brazil. As I have emphasized in my paper, [Can we Grow Rapidly?], whatever the dynamism of Southeast Asia, I find it unlikely that these countries [the Asian NIEs] are going to be the growth pole or the locomotive of the world economy. They may perhaps be able to grow relatively rapidly on their own, for a long time.

MR. BANETH: What would it take to be a growth pole? Should there be only one [pole at any given time?]

Multiple locus...

PROFESSOR BRADFORD: One of the things that has concerned me in this discussion is: Isn't the search for a single engine of growth part of the problem? Part of the juncture we face, I think, unless one is more optimistic than I think we can be, is that either the world economy turns towards a return to the trilateral center and growth pole of the world economy between Japan and the U.S. and Europe, or it continues on this path that it has been on from the early 1970s, by incorporating progressively more economies into the world economy that is, by increased openness in which case there really isn't a single locus for growth stimulus in the world economy, but a multiple locus.

And that is why a systemic cooperative solution is the one that works and why the models that try to limit a focus on the large *economies do not show the full impact of a cooperative solution on the world economy as a whole, because there are indeed not just three loci, if you like, but rather, in this conception, there are as many as 25 or so economies which, either because of their size or because of the ratio of their trade shares to GDP, are crucial to the overall outcomes of global economic growth.*

So it is a much more diffuse process than the one of seeking where the center of gravity of world economic growth is, because in fact there isn't one, but there are multiple centers.

MR. LINN: *Maybe that distinguishes the post-war period from the other periods of growth, namely that if you look at the data on GDP growth rates, everybody grew very rapidly at the same time, the developing countries as well as the industrial economics. While in the earlier periods, the Americans were growing most rapidly in the late 19th century.*

So the question is: Was it coincidental that happened? Is it something that won't come back? Will you have these smaller growth poles (such as East Asia), but they won't be able to pull the world along in the future? Or is there a way through coordinated policies to get everybody to come back up to a, say, 3.5 percent [per annum] growth rate together? One group of 25 percent of world GDP, one relatively small group, growing at 4 or 5 percent [per annum] isn't going to do the trick.

MR. BANETH: *I would like to come back actually to something which Steve Marris said, about the movement in the weight of the developing countries in the world economy.*

If we focus our attention on the impact of developing countries on the industrial countries, then I believe the answer tends to be: relatively limited, because there are a lot of developing countries that are so small that even together they don't weigh much in the international economy.

If we look at the impact of the rest of the world on some of the developing countries, I think we get a somewhat more positive answer. While Mexico or Brazil or Korea, may not have much of an impact on the United States today, they may play a role. Their weight relative to the weight of Africa is not very dissimilar to the weight Europe had relative to Africa 30 years ago.

And in that sense, they may be increasingly replacing this particular growth impulse in terms of demand for primary commodities and the rest.

Financial markets...

MR. OHLIN: I do miss the question of what the transnationalization of many important and particularly dynamic sectors in the world economy means, and this whole perspective of the erosion of the national state.

I don't know how seriously to take it and how far to go. But I do think that to discuss things in terms of national units as if nothing had happened is rather difficult.

There is no major company in the world now that isn't producing all over the place, and it allocates according to what it finds useful. Does this only mean that markets become more effective, or does it add some new dimension?

Similarly, we have referred to the new financial market and the fact that they tend to drive the exchange rate system. But we haven't really incorporated the implication of this and its tendency to reduce the importance of national policymaking, especially in the monetary field.

Some people who write about this perhaps overplay it. Nonetheless, I think if we are talking about the problem of how to get more stability into exchange rates, we have to come to grips with the fact that we have a totally different financial market in the world than we used to, and that we have been assuming or hoping that coordination of national or macroeconomic policies could do it.

There are lots of references, especially in the Armington/Fardoust paper, to this, and in the draft of the paper for the World Development Report. It seems to me that these discussions lead one to the conclusion that it is totally unlikely that some sophisticated coordination could come about.

You have said as much, Jean (Baneth). You don't believe that governments would be able to do it. But I haven't heard anybody suggest what else we think might possibly be adopted.

There is a reference to the hope or fact, in the Armington/Fardoust paper, that these necessary institutional changes will come about or history will somehow produce them. Can we guess in what direction they would have to go?

I would think they would have to go in the direction of a return to some kind of standard. We were in the global economy before the First World War. We are returning to a global economy in a way, and yet of course we can't have a gold standard. So what kind of standard could there be?

I must say I have been amazed at the discovery that in the U.S. Treasury people have been quietly studying commodity standards *for decades, and the other day [Robert] Heller wrote in The Wall Street Journal about the possibility of a commodity standard.*

There are lots of other people around who feel that sooner or later something like that will have to be taken seriously again, as it was at various times in the past, for instance, at the first UNCTAD when Kaldor and Hart presented a detailed technical proposal, for a commodity standard.

MR. O'BRIEN: A more concrete point then is: [supposing that] we have in the technological developments of the 1980s the seeds of faster growth in the 1990s, then is that actually good for the non-OECD countries, for the non-industrialized countries? The gap between where they are and where the industrialized countries are is great enough at the moment for them to work a miracle without actually having to catch up on yet another advance in the OECD countries.

Linkage between OECD and developing countries...

MR. STEER: On the linkage between OECD growth and developing countries, I would be interested to know whether people think that the Armington and Fardoust kind of numbers make sense, because Professor Boltho said just a minute ago that in the old days all the fast-growing developing countries really did it because we were growing in the OECD countries through trade, and now they have got to learn how to do it without the industrial countries.

But unless you look at the numbers that are presented in this paper by Armington and Fardoust, in fact you see that even under a rather gloomy OECD economic situation, the 2.5 percent solution, you have got trade growing, if they are right in volume terms and you have got the terms of trade improving.

You have got trade growing at almost exactly the same rate, well, slightly lower but not much lower than in the 1965 to 1986 period, in 1990s.

I mean, if these numbers are right, we really must nip in the bud Professor's Boltho's idea that the developing countries should not rely on OECD and trade.

Now these numbers may be quite wrong. In the 1965 to 1987 period you have got an average 3.3 percent [per annum] GDP growth in OECD, which permitted export volumes of the developing countries to grow by 4.2 percent [per annum]; you have got a much lower OECD growth in the projected period [of about 2.8 percent per annum], leading to no lower growth in LDC's export volume.

Now you have got terms of trade improving for developing countries, not as much as they did apparently i.. the 1965 to 1986 period, but, it still looks pretty good.

MR. VERSLUYSEN: My intervention is more out of parochial self-interest for the WDR (World Development Report 1988). To the extent we make projections [which are not forecasts] in the WDR, I could see a base case emerging where a recession doesn't necessarily take place, but world economy gets locked into a low growth scenario in the near-term, which is then extrapolated in the longer term through the end of the century also in low growth. It is difficult to see how high growth can result after a period of low or no growth.

High and Low Growth Scenarios...

This may sound paradoxical, but then if we have a low case and a high case deviation from the central scenario, I could see the high case even more paradoxical, subject to a number of qualifications; that the high case would in fact presuppose in the short-run a recession, but a recession which can then only lead to a high case without the qualifications of technology and possible other systemic shocks. But where will the main systemic shock come from? Out of a recession come two things: that the individual OECD countries would not try each to grow out of the recession on its own but in a concerted fashion, and that, somehow, greater financial discipline, potentially through greater aggravation in the financial markets, particularly the foreign exchange markets, would put checks and balances on the likelihood that the dollar would bottom out in the very near future and then start escalating again within the next 18 months.

So in a sense the shock that comes out of the recession should be a systemic shock which also brings about, galvanizes the wisdom and the ability of the various governments to actually cooperate with one another.

MR. LARSEN: Obviously, the question of the linkage between growth in the developing countries and in the industrial countries is an extremely crucial aspect of this whole discussion.

More on the linkage...

I wonder if it would not be useful to begin perhaps to explore the possibility that the link may be less strong than we believed in the past. And, indeed, as I read the numbers, I think it will be very difficult to defend the hypothesis that high growth in the industrial countries is a necessary and sufficient condition for high growth in the developing countries.

Indeed, I think high growth in the industrial countries is neither a necessary nor a sufficient condition. I think what is interesting to examine is the kind of trade performance the develop-

ing countries had when growth was high in the industrial countries. I think it is rather disappointing that their actual growth rate was only 4.2 percent given that world trade growth over this period must have been significantly higher.

Exchange rates of developing countries...

Now I wonder if this does not have something to do with the fact that, during this period, developing countries' exchange rates generally were extremely overvalued and became increasingly so, which essentially distorted the relative price structure in these countries.

MR. BANETH: *We have just completed a research project looking at oil-importing developing countries' exchange rates from 1960 to 1984 in real terms [Adrian Wood, "Global Trends in Real Exchange Rates, 1960 to 1984", World Bank Discussion Papers, 35, 1988], which shows that with only a few exceptions they were on a devaluing trend, in real terms, relative to those of industrial countries. And that is until 1985 when the dollar [began to fall.]*

MR. LARSEN: *I agree that they were on a devaluing trend, but I believe that they may still have been overvalued.*

In other words, if the exchange rate problem is being corrected, I think that there is a significant potential for the developing countries' trade to expand but it doesn't follow necessarily that there is significant scope for expanding their shares of world markets as much as Japan expanded its share of the world market previously or as the Asian NIEs are expanding their share now.

In order for them to be able to do that, it is necessary that investment be stepped up again. On my recollection, IMF figures show that the investment ratio in the developing countries fell very sharply in the first half of the 1980s compared to the previous period.

What kind of policies are needed to increase the investment ratio again in order to allow these countries to exploit their potential and to build up an export potential?

I think that is at least as important a question as the question of the pull from the industrial countries.

MR. LIPSCHITZ: *Andrea Boltho has raised the point of whether we can get internally-generated demand growth in the LDCs? And I think Steve Marris raised the point of whether we can get internally-generated demand growth in Europe, given its current structure.*

Growth in Germany...

First, the issue in Europe -- and Germany has been the focus of the discussion -- is that, growth in Germany has relied on export impulses or fiscal impulses that could not be sustained. Can we get internally-generated growth, that is sustainable in Germany?

From where we are now, fiscally, I don't see that we can have government-generated growth over the longer-run in Germany. Therefore we should seek to get growth impulses that originate spontaneously in the private sector. To do this, it will be necessary to deregulate a very regulated economy.

It's not that I believe that there is an enormous amount of additional growth that can be achieved by deregulation. But only that the deregulation of markets is the only thing I can see that could generate a higher rate of sustainable growth without relying on ever-growing fiscal deficits.

If you believe that fiscal deficits are self correcting, look at the U.S. over the last few years and see if you still believe it.

The second point raised [by Steve Marris] in this connection -- and again here I am looking at Europe's contribution to growth -- is the exchange rate system, the EMS in particular. There is the idea that Germany rides on the back of the EMS. It gets tremendous competitive gains; it shelters itself from fluctuations in the dollar. This view, however, is incomplete.

We have a situation now where much of the world is looking for a stable nominal anchor -- and there is an apparent desire for one hard currency. Thus, we have the interesting situation of everyone complaining about the Deutsche Mark, yet the Swiss, the Austrians and now the United Kingdom are pegging to it and using this peg as their credible financial policy.

If you want a credible anti-inflationary threat, you need to peg to a rock; you can't peg to a marshmallow! If you say they should peg to Italian monetary policy, that would be a marshmallow! So, sure, there is a cost in having a very hard Deutsche Mark at the center of the EMS, but there is also the benefit of believable financial stability.

The third point is whether we could find demand policies that would generate stronger domestic demand in Europe. Well, what does one want here? In 1986 and 1987, terms of trade gains generated much additional purchasing power [3 to 4 percent of GDP]. These gains were coupled with tax cuts [another one percent of GDP] and yet there wasn't much in the way of a demand response.

Clearly, there is some structural problem here. It is not simply that households and corporations lack purchasing power, but that they aren't using it. Thus far, atleast increases in real income are going mainly into saving rather than into spending. It seems to me this is prima facie evidence of a structural problem that needs to be addressed and corrected.

Prospects for the European countries...

MR. MARRIS: Well, I would love to respond on Europe and Germany, but I think taking a global view, as I said, I am not sure whether we may not have to lower our expectation of Europe. It is an interesting question.

I want to come back to the global picture, and take the Boltho's historical perspective. You know, when civilization was in only very small bits across the world, you could have a gold discovery or the opening up of the West or something like that. That was a dynamic factor which pulled parts of the world along.

We have got a much bigger and more diverse world now and, therefore, I think that it is more likely to be ideas rather than events that are going to have an important influence on the future.

I do believe that the Keynesian idea -- you could even have an historical determinist's view of the evolution of the Keynesian idea and I think Boltho keeps harking back to this -- played an enormous part in the golden era of the 1950s and 1960s. Like all of these ideas, they belong to an age and point in time, and they deteriorate in value when they have been successful, which is the case there.

The developing world...

Now I think that there is a new idea; it [really] isn't new at all, but its day has come in the developing world. It may be said that it is Prebisch (Raul) turned upside down. It is that prices are important, that there are certain key macroeconomic prices you must get right. And we talked about exchange rates here. There is a complete revolution, I think, in the recognition at least among the establishments of almost all Latin American countries, really in all countries, even the Chinese, that governments should get out of the business of production. There is a new view of the division of responsibilities. It's not new to us, but it is new to them. In the majority of the world it is a new thought, that the government's role is not one of producing but rather regulating or providing public goods and so on.

I am enormously struck by the fact that in Latin America import-substitution, the old view, and the views of the role of the state are completely discredited, and that the technocrats are all speaking the same language, virtually.

Latin America...

Then that doesn't mean that that is the answer because you have got to have the political stability, you have got to get the political establishment prepared to have the courage to follow this through. And if you look at Latin America, you can see those parts of the world where it is not being carried out. I find Mexico extremely exciting. There has been a big change in Mexico since 1982, its [manufactures] exports have increased by 40 percent [in 1985-87 period].

And there is a fundamental belief in the future of some of these [large] developing countries, which is not what you find in Europe these days. But I think the frightening thing in a sense is that this [rapid economic change] has been associated with a move towards democracy in a number of countries. Democracies are extremely fragile and some of the pain associated with switching from paternalistic economic policies to [a new mode] of economic policy may be more than some of these democracies can take. But I maybe wrong.

But still I think there is a great deal of optimism about these changes; but that wouldn't be enough. However, I am still optimistic about the U.S. The great thing about the U.S. is that it is flooded with people from all over the world who want to work extremely hard, and who are keeping wages down and who work at night. A large number of these new emigrants happen to have high IQs and they are coming out of MIT and every-where, winning all the science prizes. The country is just incapable of being either governed or regulated enough to do great damage to its internal dynamics, and it is going to survive, as long as it keeps its macroeconomics right, and that of course is a big consideration.

Now this leads me to the question of coordination. I find myself extremely uneasy with what I regard as idealized sort of views that emerge from the papers presented here and from some of the things said. Perhaps if we are lucky, we will need a more or less 1930s' recession to lead to a situation in which we could do a major rebuilding of the institutional and political structure necessary for coordination. At the moment, I don't think that is what we are headed for. So it's going to be much more messy, a bit-by-bit business.

Yen/dollar liaison...

One element in it I think is emerging, which is that there will be a Yen/dollar liaison. Lately [early 1988], the relations between the U.S. and Japan have become so integrated that it is very likely that the political interests on both sides will be sufficient to lead to a situation in which both countries are prepared to do whatever is necessary to prevent that exchange rate from fluctuating as it has in the past. If that were true, an awful lot of the developing world is going to forget about Europe and is going to peg into that in some way or another. And that is one scenario.

You could have an optimistic scenario for Europe. I said I had written it off, but I wouldn't entirely. First, taking Germany itself, you know this rock onto which Europe has locked itself was, I argued, very valuable in the first half of the 1980s. It is now like a rock which is being tied to somebody's leg and they have been thrown into the river, and, they have to decide whether they are going to untie it or not.

More on Europe...

There are two things. One is that I think there is one faction in Germany which has not accepted the view, the generally depressed view, of future slow growth. When I talk to German businessmen, they don't accept the idea that they are condemned to technological backwardness and to the loss of all their world markets and all the rest of it. Indeed, they are not yet technologically backward. So far they are not too worried or they haven't been for the last twelve months because they have been wiping up the rest of Europe. But I believe that the reaction from the German business community, if and when EMS breaks down, will be virulent.

The other thing is that there is one ambitious country left in Europe and that is France. And I just don't think France is going to sit down and tie itself to this pessimistic view of the world. I am extremely impressed by the very substantial structural improvement that is taking place in the French economy. Profits are up; inflation is down. There has been an immense amount of restructuring. There is a lot of technological change going on.

Now, there are problems like the French educational system and a good many other things. But I don't think that Europe is going to go down the drain without at least trying, and I think it is going to be very interesting to see whether it could put its act together, which will be very difficult.

A more managed financial system...

To sum up, I think that it is reasonable to suppose that the troubles we are going to go through in the short-run will generate enough of a move to a somewhat more managed financial system, and that is now a new standard or fixed rates or even John Williamson's target zones. It may be something much more pragmatic than that, which is the sort of agreement between the President of the United States and the Prime Minister of Japan, that we will work together on this and there may be some point at which the Europeans come rushing in and say, "Hey, we would like to join in this too", which is what happened, of course, when the "Group of Two" started meeting. Thus, the ideal outcome is enough trouble ahead to make sure that the lessons have been learned and that we get the minimum necessary degree of greater financial stability.

Furthermore, if we look at what can be done, or is being done, in terms of policy reforms we may revise our view of the link between the developed and the [developing]. The interesting thing is that [it used to be the case that] with good growth in the North, *we [had] good growth in the South, even in parts of Latin America when they were following the most awful policies.*

Now it may well be that with less good growth in the North but with better policies in the developing countries, they can grow just as well if not better. The world is changing. It may well be that [developing countries] will become the dynamic force which is helping us along, not necessarily immediately, but if considering twenty years out, it seems perfectly possible.

<u>MR. BANETH</u>: I would like the IECAP representatives to answer on the specific technical questions on the investment ratios and the linkages in the projections.

<u>MR. FARDOUST</u>: The historical figures on investment ratios for the developing countries, particularly for the 1980s, are heavily influenced by the performance of China and India.

For many countries, however, there has been an extraordinary decline in the investment ratios. The disaggregated figures show a collapse in Latin America and Sub-Saharan Africa in the early 1980s, while, by and large, the East Asian countries -- even if one excludes China -- maintained their investment ratios. Our baseline projections show that if real interest rates begin to decline and world trade and commodity prices recover in the next few years, both imports and investment ratios in many developing countries will begin to improve in the 1990s.

More on the North-South linkage...

<u>MR. ARMINGTON</u>: On the question of the linkage between export volume growth of the developing countries and GDP growth of the industrial countries, I have a couple of points to make. Basically, our projections of developing country exports come from our so-called central case, which essentially is a report on the Country Economists' Survey [the long-term survey of the Bank's country specialists.]

developing countries' exports...

Looking at historical data, as Andrew Steer pointed out, our baseline projections for export volume growth of 4.2 percent [per annum] from 1986 to 1995, for developing countries, looks a bit high in relation to either their GDP growth of 4.0 percent [per annum] or real GDP growth of industrial countries of 2.5 - 2.8 percent [per annum]. That is the point at issue here.

That figure of 4.2 percent essentially is the aggregation of what the country economists say is, in effect, their export supply forecast, given the policy sets that they are assuming. It is also heavily weighted by the export performance of the NIEs.

MR. BANETH: The crucial question is whether the pattern of imports, which will prevail in industrial countries in the 1990s, will be broadly that of the 1950s/1960s when they had imports increasing at about the same rate as GNP, or of the 1970s and indeed, give or take a few periods, 1980s, where imports into the industrial countries were increasing much faster than GDP; and whether you can have a continuation of that pattern of rapidly increasing imports with relatively slower GDP growth. Is that compatible with the politics and economics of the case?

MR. ARMINGTON: The baseline scenario for the industrial countries, showing output growth of 2.5 - 2.8 percent in the next decade, is probably a fairly pessimistic scenario, particularly in light of liberalization policies that may be in the pipeline.

So it could very well be, as Mr. Larsen and others have suggested, that sufficiently favorable domestic policies, supporting export growth well in the developing countries, could overcome all evils and produce export growth in excess of 4 percent. It is really possible.

MR. LARSEN: With this kind of growth projection for the industrial countries and developing countries, assuming that you would have world trade growing by something like 4, 4.5 percent, your export projection for the developing countries implies that they will barely maintain their market shares today, which I should have thought is highly unlikely.

MR. BANETH: I think you have to separate this between manufactures, where they have been consistently increasing their market shares, and primary commodities, where trade is growing less fast than overall trade and the effects are differentiated.

PROFESSOR BOLTHO: Onto the longer-run now. The purpose of this meeting, I think, to some extent was to see what the prospects for growth to the end of the century were likely to be. I am not sure that much consensus has been reached. Mr. Baneth will be summing up later, but let me suggest a couple of points that have been made or might be relevant.

Long-run prospects for growth and the LDCs...

Basically, the issue was about OECD, but Stephen Marris has made several very important and interesting comments on the LDCs. I think he would agree, however that even if the LDCs' growth goes on being relatively rapid and possibly accelerates, any feedback on the industrial countries will have to wait for the next century. For the

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world economy as a whole this cannot be all that significant through the next ten years. It will be good for the LDCs, but not much more than that.

When it comes to the industrial countries, apart from a remark by Marris at one stage, which he didn't follow up, according to which in fact he was rather optimistic and he thought that the 1990s, once transition is over, could generate fairly rapid growth, (four percent growth, I think was a figure that was suggested) most of the other comments have been actually fairly gloomy.

On the one hand, Flemming Larsen, suggested the inevitability of 2.5 percent because of the historical record. Several other people, including myself, were probably pessimistic not because of inevitability but because we saw that the probability of a recession, perhaps not serious enough to generate a new consensus and a completely reformed international monetary system, but serious enough to erode confidence yet further -- a bit like the 1974-75 recession generated a lower growth path, which then was lowered further because of the 1980-82 recession.

A new recession in 1989, 1990, 1991 could have a further negative effect on investment propensities, on confidence and so on. Now that is taking the gloomiest view, which would really limit the industrial countries' growth in the 1990s to two percent or possibly less.

There may be compensating effects here. There may particularly be the much greater dynamism of Japan and the United States vis-a-vis Europe, so that Europe sinks even further, Japan and the United States manage a good deal better. I don't think that a consensus has been reached at this meeting that for the OECD we should be expecting much more than 2.5 percent [growth per annum] for whatever reason. The LDC's may be a different story.

MR. BANETH: I don't think we have on the whole the feeling that innovation and technological change are going to be bottlenecks for future growth. So to come to Boltho's issue of whether there is a physical constraint on growth in the industrial countries, we may disagree as to how much that constituted a constraint in the 1980s. But I think the general feeling here is that it will not be a constraint in the 1990s.

New growth in the U.S....

I think we see, some of us with greater strength than others, several institutional constraints. Perhaps the most optimistic view is that somehow new growth will emerge in the U.S., because of its national dynamism, and in Japan and developing countries. Whether these impulses will support a higher growth in Europe, that is a problem for the Europeans; but they really will constitute a fairly dynamic growth in the 1990s for the rest of the world. I *think we have seen that there is general consensus that widely gyrating real interest and exchange rates have constituted a constraint on investment.*

But there is [also] a consensus that something needs be done to stabilize exchange rates to some extent, at least to get the investment going, to boost confidence of private investors.

The issue of the huge surpluses...

I don't think we have handled very much the issue of financial mechanism. Is there a need for such a huge surpluses by some countries? Some of these economies are fairly strongly geared to such surpluses. I think Boltho kept referring to this sort of mechanism in Asian NIEs. There is perhaps also a broader mechanism of the sort at play in Europe and Japan. And if you need surpluses, you need deficits; you need, in some sense, solvable deficits to compensate for the surpluses. We will have to consider further whether the Triffinian dilemma, enlarged to the world economy and to a different system, is still plaguing us. I happen to believe that it is.

Despite the insistence placed on the remaining structural constraints, I do not think we got very much, in terms of the growing structural rigidities having caused the slowdown. I think what some are saying, is that removing some of the remaining or existing structural rigidities, is one of the few places where one can get a boost. I wouldn't disagree with that; I don't think anybody would disagree with it even if we might discuss how much of a boost it will give. I don't think we had very much support for the theory that somehow these rigidities were mounting and that is what caused the slowdown.

Problems with 2.5 percent "solution"...

I think there would be general agreement with a characterization that one needs lots of good conditions. For fast growth one needs a good shock to initiate it, and then one needs lots of good developments for the growth process to continue. And if any one of these good conditions disappears, one will have a much slower growth.

And because one needs lots of them, the general feeling, with the possible exception of Marris, thinking about the recovery period, is that we are not likely -- to come back to growth rates well in excess of 2.5 percent in the medium-run -- unless some policy yet to be characterized and defined emerges. It is not a conclusion of the discussion, but my own intimate conviction, that 2 percent is not a stable outcome.

I don't believe that politically and socially for Europe, but also for the rest of the world, in some sense, that is a stable outcome. I don't think that whatever is left of the international economic system, including some free flow of capital, and to a very limited extent of labor, and to a very marked extent of goods, will survive, over the medium-run under the social, political pressures of that slow growth rate.

So, in effect, while in an economic sense I see that as being the most likely outcome, and nothing which we have said during this meeting changed that feeling, I think the 2.5 percent outcome is not going to work over the 1990s.

I see the consequences of a slowdown, of the recession, both socially and politically, for countries which now have 10 percent unemployment; for a trade system which now is under serious stress as contrasting to a sort of dynamic momentum in the 1960s, I see the consequences of the slowdown for the developing countries, where the debt problem has been heavy for the past seven years, where democratic regimes are under heavy pressure. So I see that the recession could have much more severe consequences than perhaps Boltho is forecasting.

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